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HERCULES REVISITED: AN EVOLUTIONARY MODEL OF JUDICIAL REASONING

*Catherine Valcke**

Introduction

Views about judicial decision-making may be broadly, and thus necessarily unfairly, described as either "rationalist" or "antirationalist." Whereas antirationalists picture judges as enjoying full discretion when deciding cases, rationalists describe the judicial function as one constrained by standards.[1] Legal theorists endorsing the latter position may, for the purpose of the present essay, be further classified as "externalists" or "internalists" according to their conception of the source and nature of these constraining standards.

Externalists maintain that the standards for normative legal thinking, that is, for determining whether laws are desirable or not, are necessarily external to the legal system itself. In other

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[1] Herbert Wechsler describes this debate forcefully in his seminal essay, *Toward Neutral Principles of Constitutional Law*, 73 Harv. L. Rev. 1 (1959). For practical purposes, I do not distinguish Critical Legal Studies (CLS) scholars from 'Wittgensteinian" antirationalists in this article. This is because even if some Critical legal scholars do not qualify as Wittgensteinian, in that it is the rationality of adjudicative standards, as opposed to that of the adjudicative process as a whole, that they challenge, Critical legal scholars unite with Wittgensteinian scholars in attacking rationality in law. *See, e.g.*, S. Fish, Is There a Text in This Class? (1980).

Of course, the division between the Critical legal scholars and Wittgensteinians is far from hermetic; many scholars qualify as both. *See* Hutchinson, *Part of an Essay on Power and Interpretation (with Suggestions on How To Make Bouillabaisse)*, 60 N.Y.U. L. Rev. 850 (1985).

words, externalism denies that standards for what ought to be can be found in what actually is. Classical lawyers and natural rights theorists, law and economics scholars, and various types of social contract proponents exemplify externalist thought. In contrast, internalists claim that adjudicative standards are contained within the law. Impregnated with Hegelian undertones,[2] internalism fuses what is with what ought to be.[3]

Ronald Dworkin's model of judicial reasoning is rationalist. In *Taking Rights Seriously*,[4] *A Matter of Principle*,[5] and more recently in *Law's Empire*,[6] he invokes the existence of constraining standards to oppose the view that such judicial decision-making is entirely discretionary. His model does not, however, fit the traditional either/or paradigm put forth by positivists to describe the judicial function. According to positivism, judicial decision-making is either a process of objective discovery or one of subjective creation. Breaking with this tradition, Dworkin defines the decision-making process as interpretive, thereby combining aspects of both objectivity and subjectivity. The first claim of this article is that, in so doing, Dworkin provides a credible account of the rationalist dimension of adjudication. But Dworkin's model is also internalistic; he argues that adjudicative standards are to be searched and found within the legal tradition of a particular jurisdiction.[7] The second claim of this article is that, in endorsing an internalist form of rationalism, Dworkin goes astray, for internalism is unworkable.

In support of these two claims, that judicial reasoning is

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[2] I am indebted to Roderick Wiltshire for pointing out the distinction drawn here between Wittgensteinian and Hegelian legal thought.

[3] It is surprising to note that, despite their trademark to the contrary, many positivist arguments have a clearly internalistic flavor. *See, e.g.*, H.L.A. HART, THE CONCEPT OF LAW 97-107 (1961) (discussing source of rule of recognition which underlies any particular legal system). According to Hart, the law is to evolve circularly out of the rule of recognition in a way that merges the *is* and the *ought*. Consequently, that very rule itself is to be derived from a habit of obedience by the officials. *Id.* at 144-50.

[4] R. DWORKIN, TAKING RIGHTS SERIOUSLY (1978).

[5] R. DWORKIN, A MATTER OF PRINCIPLE (1985).

[6] R. DWORKIN, LAW'S EMPIRE (1986).

[7] For a similar view, see Fiss, *The Death of the Law?*, 72 CORNELL L. REV. 1, 8-15 (1986).

both rational and non-internalistic, it is useful to compare the Dworkinian model to the ideal model, which I suggest is rational and externalistic. In *Objective Knowledge: An Evolutionary Approach*,[8] Karl Popper promotes such an externalistic model for reasoning in the field of so-called "pure" sciences. This model, I submit, may be translated into legal terms to provide an accurate account of judicial reasoning. In this article, therefore, Popper's scientific model is used as a benchmark to identify, correct, and reach beyond the flaws in Dworkin's judicial model. I argue that the inconsistencies in the latter model flow from Dworkin's internalism and that the key to Hercules'[9] rescue lies in Popper's externalism. In addition, I submit that, once modified, the Dworkinian model supports the view that legal knowledge is not different in kind from scientific knowledge as described by Popper.

However, the elaboration of a model is but one step in our understanding of legal reasoning. The existence of standards for legal interpretation is assumed in this essay; the nature and content of such standards must be subsequently explored for the model to become functional. This article addresses only the first step in forming the model. Questions concerning the existence and content of legal standards are left for future study. For now, it is merely hoped that the model's workability will make the assumption of their existence intuitively appealing.

The first two parts of this article have parallel structures. Dworkin's theory is described in Part I; that of Popper is presented in Part II.[10] Part III draws parallels between the legal and scientific models which reveal the inconsistencies in the Dworkinian model. These inconsistencies are then rectified by resort to the Popperian model. In conclusion, it appears Dworkin's model must be reinterpreted as externalistic if it is to maintain its consistency.

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[8] K. Popper, Objective Knowledge (1972).

[9] Hercules is Dworkin's ideal judge. *See* R. Dworkin, Law's Empire, *supra* note 6, at 239 ("superhuman intellectual power and patience"); R. Dworkin, Taking Rights Seriously, *supra* note 4, at 105 ("superhuman skills, learning, patience, and acumen").

[10] The various sections of this essay are not mutually exclusive; some overlap is inevitable.

I. Dworkin's Model of Judicial Reasoning[11]

A. *Law as Interpretation*

1. The Nature of Interpretation

Dworkin denies that the judicial function needs to be classified as either descriptive or normative.[12] The former classification is known as positivist; it implies that law is a set of brute facts amenable to objective description and that judges are able to discover impartially what the law is. Normative classification is associated with natural law jurisprudence; it entails the absence of objective formal constraints and presents judicial reasoning as a discretionary appraisal of what the law should be.[13] Although positivism and natural law diverge radically with respect to the nature of the constraints exerted upon judges, they unite in taking a simplistic view of these judicial constraints. Indeed, Dworkin rejects both positivism and natural law, believing the distinction between these two conceptions of adjudication to be one of degree, rather than one of kind. He offers an alternative to these two extremes which combines both positive and normative conceptions: judicial decision-making is "interpretive."[14]

Dworkin suggests that interpretation in law is better under-

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[11] This account of Dworkin's theory is the product of an integrated reading of his three monographs. Some have claimed that the views expounded in *Law's Empire* cannot be reconciled with Dworkin's previous writings. It is hoped that the discussion in Part I will convince the reader that this claim is wrong.

[12] R. Dworkin, Law's Empire, *supra* note 6, at 262.

[13] *See, e.g.*, The Natural Law Reader (B. Brown ed. 1960); A. d'Entrèves, Natural Law: An Introduction to Legal Philosophy (1951); H. Rommen, The Natural Law: A Study in Legal and Social History and Philosophy (1947).

[14] R. Dworkin, A Matter of Principle, *supra* note 5, at 147-48, 153.

Elsewhere, Dworkin describes in different terms this middle ground between positive/descriptive and normative/evaluative conceptions of adjudication. After criticizing the traditional boundary between descriptive analysis of the content ("grounds") of law and subjective evaluation of its force ("value"), he suggests:

> [A] theory about grounds, which in itself takes up no controversial position about the force of law, must nevertheless be political in a more general and diffuse way. It does not declare what a judge should do in any particular case; but unless it is a deeply skeptical conception it must be understood as saying what judges should do in principle, unless circumstances are special in the way just noticed.

R. Dworkin, Law's Empire, *supra* note 6, at 112.

stood by comparison with its counterparts in other intellectual fields, such as the physical sciences, literature, and history. Rejecting the traditional classification of interpretations as either "conversational" or "creative,"[15] Dworkin contends that all interpretation amounts ultimately to a "creative" reconstruction of the interpretee's signals by the interpretor.[16]

Literary interpretation is used as one illustration of reconstruction. A situation can be imagined where a group of novelists undertake to write a "chain novel."[17] Each novelist is in charge of writing one chapter, but for the resulting novel to make sense, it is important that the work be harmonized. Hence each novelist must first interpret the chapters previously written in order to write the following one. The reconstruction process is described by Dworkin as follows:

> Each novelist aims to make a single novel of the material he has been given, what he adds to it, and (so far as he can control this) what his successors will want or be able to add. He must try to make this the best novel it can be construed as the work of a single author rather than, as is the fact, the product of many different hands. That calls for an overall judgment on his part, or a series of overall judgments as he writes and rewrites. He must take up some view about the novel in progress, some working theory about its characters, plot, genre, theme, and point, in order to decide what counts as continuing it and not as beginning anew.[18]

The chain novel analogy illustrates Dworkin's "aesthetic hypothesis," which presents literary interpretation as an attempt to determine which way of reading the text results in its being

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[15] "Conversational" interpretation is said to be objective, in that the interpretor's role is limited to describing the interpretee's words. In contrast, "creative" interpretation involves a more complex decoding process, whereby the interpretor tries to reconstruct the interpretee's intention. According to this classification, ordinary conversation and scientific observation would belong to the first category; historical and literary decoding, to the second category. R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 50-55.

[16] *Id.* at 53, 315. "There is no longer a flat distinction between interpretation conceived as discovering the real meaning of a work of art, and criticism, conceived as evaluating its success or importance." R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 153.

[17] R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 229-30.

[18] *Id.*

seen as the best work of art. Disagreements about the correct outcome of this process will stem from the divergence of views among various schools as to the nature of a "work of art."[19]

According to Dworkin, if creative interpretation is inherent in any form of understanding, then claims of neutrality in adjudication are suspicious. Formalism's division of cases into clear/unclear, or easy/hard,[20] is groundless, in his view, because the very classification requires prior interpretation.[21] In other words, the classification of judicial cases as clear or unclear, easy or hard, is the result of interpretation rather than a "preanalytic or switchpoint distinction"[22] prior to the interpretive process. Similarly, the labelling of constitutional adjudication as interpretive or noninterpretive, and as active or passive,[23] is mistaken. The former distinction implies that judges are able to describe objectively the content of the Constitution without reference to extraconstitutional evidence;[24] the latter presupposes that, once the interpretive stage is completed, judges can remain neutral by refraining from striking down the statutory provision at issue.[25] Dworkin contests both labels.

Noninterpretivism rests upon the view that judicial interpretation is neutral when judges respect legislative intent.[26] But

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[19] R. DWORKIN, A MATTER OF PRINCIPLE, *supra* note 5, at 149, 158-59. For other illustrations of creative reconstruction, see R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 46-53; R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4.

[20] For support of this distinction, see Griswold v. Connecticut, 381 U.S. 479, 507-27 (1965) (Black, J., dissenting); H.L.A. HART, *supra* note 3; H. KELSEN, PURE THEORY OF LAW 348-56 (Cal. Library Reprint Series ed. 1978).

[21] R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 44-45.

[22] R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 353.

[23] Passivism is often referred to as "judicial restraint." *See* R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 137 (judicial restraint argues that courts should allow decisions of other branches of government to stand unless those decisions violate constitutional provisions or are contrary to clear precedent); J. ELY, DEMOCRACY AND DISTRUST 1 (1980); Wechsler, *supra* note 1, at 25 ("judicial self-restraint").

[24] *See* M. PERRY, THE CONSTITUTION, THE COURTS, AND HUMAN RIGHTS 10-36 (1982); R. BERGER, GOVERNMENT BY JUDICIARY 99-116 (1977)("open-ended" phraseology theory); Grey, *Do We Have an Unwritten Constitution?*, 27 STAN. L. REV. 703, 703-18 (1975) (historical sketch and implications of historical model).

[25] *See* L. HAND, THE BILL OF RIGHTS 73 (1958); Bork, *Neutral Principles and Some First Amendment Problems*, 47 IND. L.J. 1, 1-17, 34-35 (1971).

[26] R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 359-60.

aside from evidentiary difficulties,[27] legislative intent, or historicism, cannot be worked out otherwise than through an interpretive process.[28] Dworkin concedes that conformance with legislative intent may well be considered the right standard for evaluating various legal interpretations, just as conforming with the novelist's intent in literary interpretation may well be considered the best conception of artistic meaning. He does not concede, however, that this view is neutral because looking for legislative intent requires no interpretation.[29] Rather than being external to interpretation, historicism is, according to Dworkin, one interpretive standard among others.[30]

The apparent neutrality of the passivist option is equally misleading. Indeed, judges cannot claim to reach an impartial compromise by declining to strike down particular statutes when

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[27] Many questions must be answered before one can identify legislative intent: Who are the authors of a statute? Should we include the intent of those legislators who voted against it, the action of lobby groups, or the decision of the legislators' successors not to amend it? How do these various intentions combine? Should we attempt to extract a composite group intention or a majority intention? If discernible, should only the legislators' conscious mental states be taken into account? *See generally* R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 62-68, 317-54 (noting difficulties in determining legislative intent); R. DWORKIN, A MATTER OF PRINCIPLE, *supra* note 5, at 38-55, 163-64 (suggesting that "intention" is not waiting to be discovered, but rather there is only some such thing waiting to be invented); Mac Callum, *Legislative Intent*, 75 YALE L.J. 754, 755-87 (1965-66)(difficulties in determining legislative intent).

[28] R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 18, 53, 55-57, 359-61; R. DWORKIN, A MATTER OF PRINCIPLE, *supra* note 5, at 34-35, 52-55; R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 108.

[29] "So the speaker's meaning theory cannot make good its presumed claims of political neutrality, its ambition to separate a judge's personal convictions from the way he reads a statute." R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 316.

[30] "[There is] room for the author's intention argument as a conception of interpretation, a conception which . . . gives the intentions of legislators and past judges a decisive role in interpretation. Seen this way, the author's intention theory does not challenge the [interpretive thesis] but contests for its authority." R. DWORKIN, A MATTER OF PRINCIPLE, *supra* note 5, at 163.

In an attempt to salvage the neutrality of historicism, some have claimed that search for legislative intent is implied by the legislators themselves as the correct way to read the law. Dworkin rightly outlines the circularity of suggesting that one will find in the legislative intent the interpretation that must be given to that very intent. *See* R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 334, 364 (noting that proposition itself begs question). He refers to Powell, *The Original Understanding of Original Intent*, 98 HARV. L. REV. 885 (1985), to substantiate his position that the framers did not intend the Constitution to be read in an opaque way. R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 362 & n.7.

these statutes do not explicitly conflict with the Constitution. Judicial inaction truly amounts to "allowing state and national legislatures the last word on these issues."[31] If it can be argued that the legislator's word must prevail in the absence of conflicting constitutional provisions, judicial abstention remains, nonetheless, partial; it is a vote for the legislator.

2. Interpretation in Law

As indicated in the chain novel example, reconstruction in legal interpretation comprises several analytically distinct stages. The whole process may be pictured as a contest for the best interpretation of the law in a given case.[32] First, in the same way that the chain novelist must identify the previous chapters to be deciphered before writing, the ideal judge (Hercules) circumscribes the raw data for his interpretation.[33] At this "preinterpretive" stage, the rules and standards to be interpreted are isolated from the aggregate of all legal materials. Second, once the legal data to be interpreted are properly identified, Hercules sets out various candidates for the best interpretation, and "tentative paradigms" are formed. In the third stage, the number of tentative interpretations singled out is further reduced by a process of elimination.[34] Hercules uses a twofold standard to sort out the contestants that will qualify for the fourth and final stage of the process: the contestants must meet both the "dimension of fit" and the "dimension of value."[35]

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[31] R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 369.

[32] Dworkin applies the multiple stages of reconstruction to various judicial cases to demonstrate its workability. For his treatment of Riggs v. Palmer, 115 N.Y. 506, 22 N.E. 188 (1889), see R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 15-20; for Tennessee Valley Authority v. Hill, 437 U.S. 153 (1978), see R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 20-23; for Brown v. Board of Education, 347 U.S. 483 (1954), see R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 140; for McLoughlin v. O'Brian, [1983] 1 A.C. 410, see R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 238-50.

[33] R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 65-68, 92. Although this preparation stage is not itself entirely "purified" from interpretation, the level of agreement among various individuals is likely to be much higher at the preinterpretive stage than at other stages of reconstruction. The relatively low degree of controversy justifies the appellation "preinterpretive." *Id.* at 66.

[34] *Id.* at 92, 240; R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 107.

[35] R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 67, 230-31, 239; R. DWORKIN, A MATTER OF PRINCIPLE, *supra* note 5, at 160-61, 170.

The dimension of fit requires that only those interpretations which are consistent with previous legal materials[36] be eligible to pursue the contest for the best interpretation.[37] Hercules constructs a scheme of principles that provides a coherent justification for common law precedents, as well as constitutional and statutory provisions selected at the preinterpretive stage.[38] This scheme of principles will guide Hercules toward the single right solution for the problem raised by the case at bar.[39] The dimension of fit allows Hercules to compare various interpretations on the basis of their ability to justify the highest number of valid precedents and legislative enactments.[40] The weight of these precedents and enactments must also be conjectured and taken into account by the judge.[41] This dimension is crucial to prevent Hercules from crossing the boundary from interpretation into invention; the integrity of the law is thus guarded from the arbitrariness of judges' personal convictions.[42]

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[36] Some precedents will be set aside, however. Hercules will overrule or distinguish past decisions that qualify as "mistaken" according to the theory of mistakes he will have previously elaborated. Under this theory, a judicial decision is mistaken when it diverges from the core of precedents. It is therefore a criterion of coherence, as opposed to, for example, one of correspondence with our sense of justice, that is adopted at this level as well. R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 118-23.

[37] "His god is the adjudicative principle of integrity, which commands him to see, so far as possible, the law as a coherent and structured whole." R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 400; *see also* R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 87, 300.

[38] R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 106-07. Consistency should be vertical and horizontal. Vertical consistency demands respect for the hierarchical structure of legal materials according to their judicial level; horizontal consistency requires harmony among decisions rendered at the same level. *Id.* at 116-17; R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 227.

[39] For Dworkin's discussion of the justification for decisions according to principle or policy, as applied to Spartan Steel & Alloys, Ltd. v. Martin & Co., [1973] 1 Q.B. 27, see R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 83-120.

[40] R. DWORKIN, A MATTER OF PRINCIPLE, *supra* note 5, at 143.

[41] R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 247.

[42] R. DWORKIN, A MATTER OF PRINCIPLE, *supra* note 5, at 159.

> Each judge must regard himself, in deciding the new case before him, as a partner in a complex chain enterprise of which these innumerable decisions, structures, conventions, and practices are the history; it is his job to continue that history into the future through what he does on the day. He *must* interpret what has gone before because he has a responsibility to advance the enterprise in hand rather than strike out in some new direction of his own.

Id.

The dimension of value introduces a normative element into the reconstruction process. When the dimension of fit does not discriminate between two or more eligible interpretations, Hercules must select the winner "by asking which shows the community's structure of institutions and decisions . . . in a better light from the standpoint of political morality."[43] This "political morality"[44] is the standard against which the dimension of value of various interpretations will be measured. Yet, in the same way that disagreements over what constitutes the best work of art pervade the artistic community in the case of the chain novel, judges differ in their opinions as to what constitutes the best "work of law."[45] Indeed, each judge's perception of political morality underlying previous legal material is influenced by his subjective beliefs as to the dominant purpose of law; and, as a result, differing versions of political morality will arise within the judicial community.[46] Those who believe the dominant purpose of a legal system is economic will interpret past judicial de-

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"For Hercules is not trying to reach what he believes is the best substantive result, but to find the best justification he can of a past legislative event." R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 338; *see also* R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 109 (suggesting defenses to claim that judicial decisions about statutory purpose are calculations based on political rights).

[43] R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 256. Dworkin describes the dimension of value as complementing the dimension of fit "if two justifications provide an equally good fit with the legal materials." R. DWORKIN, A MATTER OF PRINCIPLE, *supra* note 5, at 143.

[44] In keeping with his criticism of the semantic sting, Dworkin refuses to define the concept of political morality and merely describes its function and variations. The content of political morality remains, therefore, unclear. At one point, however, Dworkin approximates a definition by alluding to some "constituent virtues of political morality." R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 249. These virtues are enumerated elsewhere as justice, fairness, procedural due process, and integrity. *Id.* at 177. Integrity is described as an "independent ideal" that stands as a compromise when the other constituents conflict with each other. *Id.* at 178. The imprecision of his discussion on political morality stems from the fact that any description is, in his view, a tentative interpretation; the door is open to competitors. *Id.* at 94.

[45] R. DWORKIN, A MATTER OF PRINCIPLE, *supra* note 5, at 159.

[46] R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 53, 88, 102; R. DWORKIN, A MATTER OF PRINCIPLE, *supra* note 5, at 162. Versions of political morality can be extremely divergent indeed. *See, e.g.*, R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 74-76 (discussing general methods by which concepts of political morality are developed); R. DWORKIN, A MATTER OF PRINCIPLE, *supra* note 5, at 159 (utilitarianism); *id.* at 163 (historicism); R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra*, at 300 (neo-Marxism).

cisions as being guided by efficiency concerns. Others might advocate a moral approach to the legal system and interpret precedents as attempts to preserve conventional morality among citizens. Such a diversity of opinions is essential, according to Dworkin, in order to prevent legal and social stagnation.[47] His tentative model of adjudication allows, therefore, for a healthy competition among interpretations of political morality.[48]

Dimensions of fit and value are therefore two necessary and independent tests in the search for the best interpretation. But if fit and value are conceptually distinct from one another, they nevertheless become entangled in their application.[49] Indeed, one's perception of political morality (value) will be influenced by the constant emergence of new legal materials (fit), and vice versa. Fit and value remain sufficiently independent, however, to check and balance each other.[50] Together, these two dimensions constitute the descriptive/evaluative combination described by Dworkin as an inherent part of reconstruction.

The three-stage selection process elaborated thus far should enable Hercules to choose the winner in the contest for best interpretation. Ties are highly unlikely; the complexity of contemporary legal materials renders the test of fit extremely difficult to pass.[51] But in the event that two interpretations "provide an equally good fit with the legal materials, one nevertheless provides a better justification than the other if it is superior as a matter of political or moral theory."[52]

For each judicial instance, therefore, the combination of institutional materials and political morality dictates a single right answer. Admittedly, the truth of this answer cannot be positively demonstrated. What can be demonstrated, however, is the relative inferiority of competing answers.[53] Accordingly, the best

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[47] R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 89.

[48] Dworkin's allowance for such competition illustrates his desire to dissociate his model from natural law jurisprudence, which "take[s] some legal statements, at least, to be purely evaluative as distinct from descriptive . . . ." R. DWORKIN, A MATTER OF PRINCIPLE, *supra* note 5, at 147.

[49] R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 48.

[50] *Id.* at 231.

[51] R. DWORKIN, A MATTER OF PRINCIPLE, *supra* note 5, at 143.

[52] *Id.*

[53] *Id.* at 139-40; *see also id.* at 153 (stating theory may be, if not correct, at least

interpretation, or paradigm, will stand as the right answer until subsequent judicial developments arise to challenge its authority.[54] Legal paradigms or "right answers" are thus not immutable. Instead, they temporarily enjoy the status of "best."[55]

Of course, judges are not Herculean. They make mistakes.[56] But error is not fatal, for Dworkin's model of adjudication is evolutionary; mistakes will be corrected, and deviations straightened by distinguishing and overruling precedents.[57] To the question of whether this correction process undermines the relevance of the dimension of fit, Dworkin answers:

> This flexibility may seem to erode the difference . . . between interpretation and a fresh clean-slate decision about what the law ought to be. But there is nevertheless this overriding constraint. Any judge's sense of the point or function of law, on which every aspect of his approach to interpretation will depend, will include or imply some conception of the integrity and coherence of law as an institution, and this conception will both tutor and constrain his working theory of fit . . . .[58]

In Dworkin's world, legal knowledge emerges out of a process of constantly correcting and refining paradigms once thought immutable, a process which serves the greater consistency of positive law.

3. A Conjecture About the Nature of Law

The previous section presented Dworkin's theory of legal in-

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best theory offered).

[54] *Id.* at 143.

[55] *See* R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 89-90 (transience of paradigmatic legal principles); *see also id.* at 110 (in flourishing legal system, legal principle must stand until defeated by better argument).

> This pattern of agreement and disagreement is temporary however. Suddenly what seemed unchallengeable is challenged, a new or even radical interpretation of some important part of legal practice is developed in someone's chambers or study which then finds favor within a "progressive" minority. Paradigms are broken, and new paradigms emerge.

Id. at 89-90.

[56] *See id.* at 245-46 (judicial interpretation allowed to expand often to point of inconsistent results).

[57] R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 119.

[58] R. DWORKIN, A MATTER OF PRINCIPLE, *supra* note 5, at 161.

terpretation. This section examines Dworkin's theory of law through analysis of his personal views on the purpose of law and his definition of political morality. To Dworkin's credit, the two theories are identical in form; only the substance differs.

a. A Concept[59] of Law

Because of their lack of specificity, more abstract statements are generally able to produce a higher degree of agreement. Hence Dworkin introduces his views on the purpose of law with a generalized concept of justice. If disagreement concerning justice remains,[60] Dworkin's concept may nevertheless suffice to capture a common core from which various conceptions may develop. Dworkin suggests:

> [T]he most abstract and fundamental point of legal practice is to guide and constrain the power of government . . . . Law insists that force not be used or withheld, no matter how beneficial or noble these ends, except as licensed or required by individual rights and responsibilities flowing from past political

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[59] R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 134-35. Dworkin classifies statements about the purpose of law as "concepts" or "conceptions," according to their respective levels of abstraction, the former being more abstract than the latter. He further contends that the distinction between concepts and conceptions is one of kind:

> When I appeal to the concept of fairness I appeal to what fairness means, and I give my views on that issue no special standing. When I lay down a conception of fairness, I lay down what I mean by fairness, and my view is therefore the heart of the matter. When I appeal to fairness I pose a moral issue; when I lay down my conception of fairness I try to answer it.

Id. at 135. This view seems, however, to conflict with his claim that all is interpretation. *See supra* Subsection I.A.1. Moreover, Dworkin admits elsewhere that concepts themselves may be a source of controversy. *See* R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 74-75 (noting discord that may surround determining "best conception of concept").

[60] Dworkin admits that the only embryo of agreement with respect to the concept of justice is stalled at the preinterpretive stage:

> We share a preinterpretive sense of the rough boundaries of the practice on which our imagination must be trained. We use this to distinguish conceptions of justice we reject, even deplore, from positions we would not count as conceptions of justice at all even if they were presented under that title. The libertarian ethic is, for many of us, an unattractive theory of justice. But the thesis that abstract art is unjust is not even unattractive; it is incomprehensible as a theory about justice because no competent preinterpretive account of the practice of justice embraces the criticism and evaluation of art.

R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 75.

decisions about when collective force is justified.[61]

Rights seem thus central to Dworkin's vision of law. Indeed, only past judicial decisions which are justified by the rights[62] of the parties, as opposed to those justified exclusively by the welfare of society, will deserve Hercules' attention when he is reconstructing political morality. The former type of decisions are termed "principled"; the latter category are classified as decisions of "policy."[63]

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[61] *Id.* at 93.

[62] Many have critized Dworkin's definition of rights as unclear or even contradictory. *See* MacCormick, *Dworkin as Pre-Benthamite*, in RONALD DWORKIN AND CONTEMPORARY JURISPRUDENCE 193 (M. Cohen ed. 1984); Raz, *Professor Dworkin's Theory of Rights*, 26 POL. STUD. 123, 128 (1978). The criticism is legitimate, since Dworkin sometimes refers neutrally to rights as "individuated political aim[s]" that may or may not outweigh policy considerations ("nonindividuated political aim[s]"). R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 91. Elsewhere, he maintains that "[t]he nerve of a claim of right . . . is that an individual is entitled to protection against the majority even at the cost of the general interest." *Id.* at 146. *Compare id.* at 91-92, 115, 121, 299-300, 309 *and* R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 107 *with* R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at xi, 147. Regan tried to reconcile the two apparently contradictory versions under a conception of rights as "preferences which are given special weight." Regan, *Glosses on Dworkin: Rights, Principles, and Policies*, in RONALD DWORKIN AND CONTEMPORARY JURISPRUDENCE, *supra*, at 119-20. The contradiction is indeed illusory, but Regan's attempted reconciliation is inappropriate, for the two versions should simply not be compared. The first one is a concept; the second one, a conception. As pointed out by Dworkin himself in his reply to Raz, our Western contemporary political morality seems to dictate the strong version as the appropriate conception of rights. R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 364. But conceptions of rights are, according to Dworkin, contingent upon political morality, and they vary accordingly from one society to another. *See supra* notes 44-48 and accompanying text. In that sense, rights as a concept may or may not effectively outweigh policy considerations, depending on the conception adopted. The social environment will be determinative.

[63] R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 294.

> Arguments of principle attempt to justify a political decision that benefits some person or group by showing that the person or group has a right to the benefit. Arguments of policy attempt to justify a decision by showing that, in spite of the fact that those who are benefited do not have a right to the benefit, providing the benefit will advance a collective goal of the political community.

Id.; *see also id.* at 89, 92 ("individual rights" refers to fundamental interests, whereas "social goals" refers to tradeoffs within community to promote economic efficiency); R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 27-28 (examining how precedents are distinguished on policy grounds).

Dworkin compares policy decisions with political grants of subsidies motivated solely by ad hoc considerations of economic growth. "In any case, we would not say that either the employers or the employees in other industries have a right in fairness to similar opportunities, simply because the same investment of administrative time and

Distinguishing principles from policy is useful in three respects. First, if judges base their decisions on principles, they are less vulnerable to charges of usurping legislative lawmaking power.[64] Second, losing parties cannot accuse judges of retroactive lawmaking, since principled judgments do not create new duties; rather, principled judgments unveil preexisting duties that have been previously neglected.[65] Finally, principled decisions provide the key to consistency in precedents.[66] As a result, Dworkin urges courts to justify their decisions with arguments of principle.[67]

The necessary distinction between principles and policies does not require that consequences be ignored in the elaboration of adjudicative principles.[68] According to Dworkin, principled adjudication requires only that rights motivate judicial decisions. This requirement does not resolve how rights are deter-

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money would have produced equivalent gains there." R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 320.

[64] R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 84.

[65] *Id.* The converse is also true; applying laws retroactively punishes a party, not for some duty he breached, but for a new duty created after his conduct. *Id.*

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> Policies are aggregative in their influence on political decisions and it need not be part of a responsible strategy for reaching a collective goal that individuals be treated alike. . . . In the case of principles, however, the doctrine insists on distributional consistency from one case to the next, because it does not allow for the idea of a strategy that may be better served by unequal distribution of the benefit in question.

Id.

[67] *Id.* at 82-83. In contrast, the legislature is not bound by the obligation of principled decisions, because its task is the advancement of social welfare. *Id.* at 83. This is not to say, however, that judges are free to disregard legislative enactments on the ground that these enactments were generated by arguments of policy. The plea for principled decisions applies solely to the common law. *See id.* at 37-39 (distinguishing between common-law precedent and statutory interpretation). As a matter of principle, all rights created by legislation command judicial enforcement. R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 338-39; R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 83.

[68] *See* R. DWORKIN, A MATTER OF PRINCIPLE, *supra* note 5, at 95-98 (attention should be paid to ramifications of practice when determining content of rights). *See generally* R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 294-304 (distinguishing principles from policies). Dworkin acknowledges, nevertheless, that allowing for rights derived from utilitarian considerations weakens the distinction between principles and policies. *See* R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 160-61 (pragmatism, which allows judges to follow method of determining disputes which they believe will best promote societal goals, leads to unjust system not based on tradition).

mined.[69] In some cases, appeal to consequences will prove useful by allowing judicial consideration to proceed from competing abstract rights to the ultimate concrete right that will resolve the case.[70] As long as judgments are based on arguments concerning the parties' rights, they qualify as principled; this is so regardless of how these rights have been determined.

b. A Conception of Law

Law has traditionally been viewed as torn between the two conflicting objectives of predictability and flexibility. While fairness dictates "treating like cases alike," it also requires that law allow for the "personalized" disposition of each case on its own facts.[71] Dworkin presents three interpretive conceptions of law—"conventionalism," "pragmatism," and "law as integrity"—and compares their respective positions on a spectrum between the antipodes of predictability and flexibility. He then evaluates these conceptions against the two-pronged standard of fit and value.

"Conventionalism" is an ideal of protected expectations.[72] Through conventionalist eyes, political morality commands respect for past convention, since "[p]ast political decisions justify

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[69] R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 299. "The story of principle supposes only that judges take the same general attitude toward questions of fairness, and appeal to consequences, in ways and with emphasis that differ from judge to judge and from period to period, just as these differ from person to person in ordinary life." *Id.* at 301.

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> An abstract right is a general political aim the statement of which does not indicate how that general aim is to be weighed or compromised in particular circumstances against other political aims. The grand rights of political rhetoric are in this way abstract. . . . Concrete rights, on the other hand, are political aims that are more precisely defined so as to express more definitely the weight they have against other political aims on particular occasions.

Id. at 93. As a result, only abstract rights are capable of conflicting. For example, if Jones' abstract right to freedom of expression conflicts with Smith's abstract right to privacy and if a judge decides that, in a particular set of circumstances, the latter outweighs the former, then Smith will have the concrete right not to be slandered in a newspaper.

[71] *See* R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 146-47 (conventionalism leads to balance between predictability and flexihility); *see also* Pound, *The Theory of Judicial Decision*, 36 HARV. L. REV. 641, 654-55 (1923).

[72] R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 120.

coercion because, and therefore only when, they give fair warning . . . ."[73] Conventionalist adjudication thus proceeds on the basis of "consistency in strategy," as opposed to "consistency in principle."[74] The former derives respect for rules from the sole fact that they are rules; the latter asserts respect for rules by the acceptance of their substance.[75] When positive convention runs out, however, conventionalism provides that judges enjoy full discretion, for then no positive legal rule applies to the case at bar.[76] As an interpretive version of literalism, conventionalism is very close to the predictability end of the spectrum. In contrast, "pragmatism" is a skeptical concept of law which rejects the connection between law and coercion, as well as the inherent value of adjudicative consistency. Pragmatist judges render whatever decision they feel will best serve the community's welfare.[77] As an interpretive version of realist skepticism,[78] pragmatism is very close to the flexibility end of the spectrum.

According to Dworkin, neither "conventionalism" nor "pragmatism" survives the elimination process in the contest for the best conception of law. Conventionalism does not fit legal practice, because it fails to explain the phenomenon of change in the substance of law.[79] Indeed, if consistency in strategy is the only requirement for adjudication, all reasons other than consistency fail at challenging the content of positive legal rules. Yet the law does evolve in substance.

Pragmatism does not offer a better account of current legal practice. It does account for the evolution of law;[80] but if the

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[73] *Id.*

[74] *Id.* at 132-33.

[75] *See id.* at 133 ("consistency in strategy" requires judge to hand down new decisions that are consistent with old ones). The convention of driving on the right side of the road is an example of consistency in strategy. The selection of the right side over the left side is not warranted as a matter of justice. The key is that all drivers agree on the same side. In contrast, the rule prohibiting gratuitous infliction of pain is approved of because of a consensus that gratuitous infliction of pain is wrong. *See* R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 144-47 (convention means acting consistently with expectation of how others will act; conviction means acting on basis of individual beliefs).

[76] *See id.* at 95 (pragmatism requires judges to act in best interest of society).

[77] R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 15-52.

[78] *Id.* at 152, 162.

[79] *Id.* at 137-39.

[80] *Id.* at 157.

only concern of judges is the enhancement of social welfare, there is no reason for them to act "as if" their decisions were determined by trump-rights unimpeded by policy considerations. The pragmatist would suggest that "as-if" justifications by judges may well serve collective welfare, in that they allow for people to "plan their affairs with more confidence."[81] Such behavior is obviously not warranted, however, when past decisions are unclear, for then "the general power of precedents to guide behavior will not be much jeopardized if judges refuse to follow them when the advice they give is garbled or murky."[82] As a result, pragmatism fails to explain why judges appear to be searching for the legislative intent underlying an ambiguous statute.

From a value perspective, pragmatism is a more desirable metaconception than conventionalism, because it allows for conventionalist adjudication when judges consider it to be in the community's best interest. And the converse is not true.[83] Neither conventionalism nor pragmatism, however, satisfies the dimension of fit required of the best conception of law. Dworkin therefore offers a third conception, "law as integrity," as an alternative.

Law as integrity "unites jurisprudence and adjudication"[84] and is offered, not only as an interpretation of the concept of law, but also as a process geared toward interpretation.[85] Con-

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[81] *Id.* at 158.

[82] *Id.* at 159.

[83] *See id.* at 149 (pragmatism makes it harder to predict outcome of "easy cases").

[84] *Id.* at 410.

[85] *Id.* at 226. "[L]aw as integrity rejects as unhelpful the ancient question whether judges find or invent law; we understand legal reasoning, it suggests, only by seeing the sense in which they do both and neither." *Id.* at 225; *see also id.* at 410 ("law as integrity" focuses on precise interpretations rather than "independent crusades").

At the same time, Dworkin insists that his jurisprudential and legal theses must not be confused. He dissociates one from the other in this way:

> The adjudicative principle of integrity instructs judges to identify legal rights and duties, so far as possible, on the assumption that they were all created by a single author . . . expressing a coherent conception of justice and fairness. We form our third conception of law, our third view of what rights and duties flow from past political decisions, by restating this instruction as a thesis about the grounds of law. According to law as integrity, propositions of law are true if they figure in or follow from the principles of justice, fairness, and procedural due process that provide the best constructive interpretation of the community's legal practice.

ventionalism and pragmatism fix certain measures of predictability and flexibility on the spectrum. Law as integrity allows for elasticity; the degrees of predictability and flexibility must adapt to the circumstances of each judicial instance.[86] Consistent with his perspective on jurisprudence, Dworkin's conception of law requires that convention be given more weight when "all things considered, [it] makes the community's legal record the best it can be from the point of view of political morality."[87] The converse is true when political morality calls instead for flexibility.

From the standpoint of fit, this conception of law does not succumb to the objections leveled against conventionalism and pragmatism.[88] Moreover, it strikes the most desirable balance between the needs for deference to institutional materials and for greater flexibility in law.[89] From the standpoint of value, law as integrity provides the best explanation for the legitimacy of coercion grounded in law.[90] Because it meets both fit and value requirements, Dworkin endorses law as integrity as the best conception of law.

Law as integrity offers a particular perspective on the role of precedent and of legislative and constitutional materials in the adjudicative process. Each of these three sources of law will be examined in turn.

The fairness requirement that like cases be treated alike finds expression in the common-law doctrine of precedent. Unlike statutory provisions that derive authority from their mere enactment, precedents constrain Hercules because of what Dworkin calls their "gravitational force." "A precedent is the report of an earlier political decision; the very fact of that decision, as a piece of political history, provides some reason for de-

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Id. at 225.

[86] *Id.* at 367.

[87] *Id.* at 411.

[88] *See id.* (law as integrity provides better justification for current legal system than conventionalism or pragmatism).

[89] R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 146-47.

[90] However interesting this aspect of law as integrity is, it is not relevant for the purpose of this essay and will therefore be omitted. For further elaboration on the value of law as integrity as a political ideal, see *id.* at 186-215.

ciding other cases in a similar way in the future . . . . [T]he force of a precedent escapes the language of its opinion."[91]

While the legislator's word is viewed as a sufficient and exhaustive basis for interpretation, judges are less explicit as to the precise rules to be extracted from their opinions.[92] Consequently, Hercules must once again undertake a reconstruction process, whereby he will search beyond the canonical formulation of past decisions for the principles they generate.[93]

For purposes of consistency, Hercules endeavors to mold the line of judicial cases into a coherent body. In the same way that a chain novel is worthless if it results in a collection of unrelated stories,[94] the value of precedent lies in its consistency as a whole; mere accumulation is worthless.[95] Thus Hercules must sort out valuable precedents, isolate the principles they illustrate, evaluate their applicability to different situations, and use these principles to resolve the case at bar.[96]

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[91] R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 113; *see also id.* at 111, 115-16 (gravitational force of precedent is defined by principles that support it and not by linguistic limits of language that announced it).

[92] *Id.* at 110.

[93] *Id.*

[94] *See* R. DWORKIN, A MATTER OF PRINCIPLE, *supra* note 5, at 159 (like novelist, judge is expected to create "unified novel").

[95] R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 240; R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 116.

[96] Dworkin uses the case of a car accident that caused emotional distress to an aunt of one of the victims as an example of precedent reconstruction. R. DWORKIN, A MATTER OF PRINCIPLE, *supra* note 5, at 160. The aunt did not witness the accident, but learned of it by radio. Dworkin explains:

> [The judge] might be forced to choose, for example, between these two theories about the "meaning" of that chain of decisions. According to the first, negligent drivers are responsible to those whom their behavior is likely to cause physical harm, but they are responsible to these people for whatever injury — physical or emotional — they in fact cause. If this is the correct principle, then the decisive difference between that case and the aunt's case is just that the aunt was not within the physical risk, and therefore she cannot recover. On the second theory, however, negligent drivers are responsible for any damage they can reasonably be expected to foresee if they think about their behavior in advance. If that is the right principle, then the aunt may yet recover. Everything turns on whether it is sufficiently foreseeable that a child will have relatives, beyond his or her immediate parents, who may suffer emotional shock when they learn of the child's injury. The judge trying the aunt's case must decide which of these two principles represents the better "reading" of the chain of decisions he must continue.

Judicial decisions based on policy considerations do not exert gravitational force; their value is restricted to their enactment force. Policy decisions will hence prove irrelevant to the disposition of subsequent cases.[97] Similarly, principled decisions which qualify as mistakes because they diverge from the core of precedent will be ignored or reversed.[98] Such distinguishing and overruling action must, however, remain exceptional, for consistency with all precedents remains Hercules' primary concern.[99]

From the perspective of law as integrity, the principle of democracy is contained in political morality and commands that judges display deference for legislative authority when this authority is clearly manifested.[100] When the outcome of a case is unambiguously dictated by legislation, therefore, Hercules is bound by the principle of democracy to follow that legislation.[101]

In so-called hard cases, statutes will also prove helpful to Hercules, for, despite their insufficiency, they constitute a solid guidepost in reconstructing political morality.[102] As stated

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Id. at 160. This hypothetical situation is very similar to the *McLoughlin* case, *supra* note 32, discussed in more detail in R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 240-50.

[97] R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 113, 318.

[98] R. DWORKIN, A MATTER OF PRINCIPLE, *supra* note 5, at 161.

[99] R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 115.

> The practices of precedent do not suppose that the rationales that recommend judicial decisions can be served piecemeal in that way. If it is acknowledged that a particular precedent is justified for a particular reason; if that reason would also recommend a particular result in the case at bar; if the earlier decision has not been recanted or in some other way taken as a matter of institutional regret; then that decision must be reached in the later case.

Id. (emphasis omitted).

[100] The possibility of conflict between statutes and political morality is examined *infra*.

[101] R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 125. When the statute is clear, Hercules need not pursue his reconstruction beyond statutory language to the constitution or, further still, to political morality. Indeed, the existence of a clear statute establishes a prima facie case in favor of statutory consistency with constitutional enactments and, more generally, with political morality. *Id.* at 105-07. Only when the constitutional validity of a clear statute is challenged will Hercules be faced with the duty to reconstruct the constitution. If the challenge is justified, then the prima facie validity of the statute is meaningless. Moreover, Dworkin acknowledges laconically that situations might arise where clear legislative words conflict with political morality. *Id.* at 326-27. In such cases, he suggests reluctantly that the judge lie and pretend that the right interpretation to be assigned to the statute is one consistent with political morality. *See id.*

[102] *Id.* at 113-14.

above,[103] Dworkin disputes the historicist claim that search for actual legislative intent is impartially uninterpretive and should be preferred to reconstruction of political morality. To reconstruct political morality, therefore, Hercules will not search for actual intent, but rather for legislative "beliefs and attitudes about justice and fairness and about which policies . . . would be most effective in making the community better on the whole."[104] These beliefs and attitudes, or "legislative convictions,"[105] may be found in the legislative history of statutes, including preparatory documents, preambles, first and second readings, congressional debates, and other such materials.[106]

Three points should be clear with respect to legislative convictions. First, these convictions may emerge from legislative history, which thus becomes useful to Hercules.[107] Second, the rejection of actual intent yields to an intertemporal, or dynamic, perspective on legislative intent; convictions evolve with sociopolitical circumstances.[108] Third, legislative convictions may be legitimately generated by considerations of either principle or policy. Once validly enacted, policy considerations create institutional rights that judges are required to enforce as a matter of principle.[109]

Constitutional interpretation differs slightly from statutory interpretation, because, Dworkin suggests, the Constitution is a special kind of statute.[110] It resembles statutory enactments, in that it too is a precious piece of evidence concerning the substance of political morality.[111] The Constitution is nevertheless special in two respects. First, it is foundational: "[i]t must fit and justify the most basic arrangements of political power in the community, which means it must be a justification drawn from

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[103] *See supra* Subsection I.A.2.

[104] R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 329.

[105] *Id.*

[106] *Id.*

[107] *Id.* at 342.

[108] "Hercules' method . . . rejects the assumption of a canonical moment at which a statute is born and has all and only the meaning it will ever have." R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 348.

[109] *Id.* at 338-39; R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 83.

[110] R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 379.

[111] R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 106-07.

the most philosophical reaches of political theory."[112] Second, there are no clear cases in constitutional adjudication. Appeal to political morality is required in each and every instance in order to translate abstract constitutional concepts into concrete conceptions that are applicable in practice.[113] Indeed, the open texture purposefully given by the founding fathers to the clauses of the Constitution[114] must be made more precise if it is to assist in the disposition of particular cases.

A pattern of concepts and conceptions seems to offer a satisfactory account of the simultaneous, and apparently paradoxical, rigidity and flexibility of the Constitution.[115] Whereas a constitution "sets out a general political scheme that is sufficiently just to be taken as settled for reasons of fairness,"[116] the various conceptions of this political theme will evolve along with "ethical attitudes that [are] widespread in the community,"[117] as well as with "popular convictions and national tradition."[118] The paradox is thus merely apparent indeed.

B. Objectivity in Law: The Issue of Judicial Discretion

True to traditional positivism,[119] Hart describes hard case

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[112] R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 380.

[113] "The difficult clauses of the Bill of Rights . . . must be understood as appealing to moral concepts rather than laying down particular conceptions . . . ." R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 147. This constitutional model corresponds to Frank Michelman's "weak-sense perfectionism," discussed in Michelman, *Constancy to an Ideal Object*, 56 N.Y.U. L. REV. 406, 406-12 (1981).

Dworkin has Hercules decide *Brown v. Board of Education*, *supra* note 32, to provide a concrete illustration of his model of constitutional adjudication. *See* R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 387-89 (discussing methodology of testing various constitutional interpretations within Dworkin's model).

[114] Dworkin maintains, indeed, that the open texture was deliberate and not the result of "botched or incomplete or schematic attempts to lay down particular conceptions." R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 136. He continues, "If we take [the clauses] as appeals to moral concepts they could not be made more precise by being more detailed." *Id.*

[115] *See* Munzer & Nickel, *Does the Constitution Mean What It Always Meant?*, 77 COLUM. L. REV. 1029, 1045-49 (1977)(embracing Dworkin's theory of constitutional adjudication).

[116] R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 106.

[117] R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 388.

[118] *Id.* at 398.

[119] H.L.A. HART, *supra* note 3, at 138-44; *see* R. DWORKIN, TAKING RIGHTS SERIOUSLY,

adjudication as a two-step process. First, there is the search for clear-cut, positive legal rules which, if they exist, bind the judge absolutely; second, in the absence of such rules, judges are entitled to set aside "the books . . . and to stride off on their own."[120] Dworkin disputes the validity of this model of judicial discretion on two grounds. First, as discussed above,[121] the model mistakenly assumes a dichotomy between acts of discovering and acts of lawmaking. Second, it presupposes that the constraints exerted on judges by institutional materials, whether precedents or legislation, are coextensive with their canonical formulation; it denies the binding power of political morality.

As an alternative, Dworkin proposes a model of two discretions.[122] "Strong discretion" is enjoyed by judges only in the absence of any standard to guide their decisions.[123] In contrast, if guiding standards exist, some discretion is still involved in the identification and application of these standards, but it remains a "weak discretion."[124] To the objection that political morality is ultimately determined by Hercules' personal convictions, Dworkin responds:

> [T]hat charge is ambiguous, because there are two ways in which an official might rely upon his own opinions in making such a decision. One of these, in a judge, is offensive, but the other is inevitable.

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supra note 4, at 31-39, 68-71 (Dworkin's description of positivist thought on issue of discretion).

[120] R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 86; *see id.* at 125 (classical theory of adjudication); *see also id.* at 129 (popular judgment of community).

[121] *See supra* Subsection I.A.1.

[122] Dworkin illustrates the distinction between "strong" and "weak" discretion by comparing two different orders given to a sergeant. R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 31-32. On the one hand, the sergeant can be ordered to pick five soldiers for a certain mission. *Id.* at 32. On the other hand, the order may be to pick his five most experienced soldiers. *Id.* In the former case, the sergeant enjoys strong discretion in the selection of the five soldiers; in the latter case, the discretion is weak since the standard of experience is provided. *Id.* Dworkin recognizes a second form of weak discretion in the statement that an official has final authority on a certain matter and is thus immune from review. *Id.* at 32. On the distinction between strong and weak discretion, see *id.* at 86, 124-26, 328-30; R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 68-69, 341; Greenawalt, *Discretion and Judicial Decision: The Elusive Quest for the Fetters That Bind Judges*, 75 COLUM. L. REV. 359, 365-72 (1975).

[123] *Id.*

[124] *Id.*

. . . .

> Hercules does not rely upon his own convictions in the first of these two ways. He does not consider the fact that he happens to favor a particular conception of religious liberty, for example, as an argument in favor of a decision that advances that conception. If the objection we are considering is pertinent, therefore, it must be an objection to his reliance upon his own convictions in the second way. But in that case the objection cannot be a blanket one, because he must inevitably rely on some of his own convictions. It is rather an objection to his reliance on the soundness of certain of his own convictions; it argues that he ought to defer to others in certain judgments even though their judgments are, as he thinks, wrong.[125]

Preexisting institutional materials provide objective standards to guide judges in their decisions.[126] But judges are not entirely objective in the selection and application of these standards.[127] Dworkin suggests that, in the same way that an art interpreter's convictions as to the purpose of art will influence his interpretation of a particular work of art, judges' convictions as to the purpose of law will play an important role in the interpretation of binding institutional standards.[128] Reciprocally, their interpretation of objective institutional materials will influence their jurisprudential convictions, for jurisprudential theories are themselves merely tentative candidates for the best interpretation of the purpose of law and are therefore subject to modification, correction, or elimination.[129] As a result, it seems that judi-

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[125] R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 123-24.

[126] *See supra* notes 100-18 and accompanying text.

[127] *See supra* note 122.

[128] R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 57-58, 90, 352. Developing his analogy with literary interpretation, Dworkin explains: "So any literary critic's style of interpretation will be sensitive to his theoretical beliefs about the nature of and evidence for a canonical text. An interpretive style will also be sensitive to the interpreter's opinions about coherence or integrity in art." R. DWORKIN, A MATTER OF PRINCIPLE, *supra* note 5, at 150. Similarly, one's convictions about scientific knowledge will influence one's account of the history of science. R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 14.

[129] "[T]heories of interpretation are no longer seen as what they often claim to be —analyses of the very idea of interpretation— but rather as candidates for the best answer to the substantive question posed by interpretation. Interpretation becomes a concept of which different theories are competing conceptions." R. DWORKIN, A MATTER OF PRINCIPLE, *supra* note 5, at 152-53.

cial opinions are simultaneously a product of and a constraint upon jurisprudential theories.[130]

Weak discretion is thus inherent in adjudication and may not be eliminated. The case for judicial objectivity is not hopeless, however. Indeed, because judges' subjective beliefs must be expressed, externalized, and formulated in order to become binding law,[131] a posteriori correction of judicial opinions, based upon the canonical formulation of these opinions, is always possible. "Articulate consistency" is all that is required for this correction to take place.[132] In other words, judges must deal with the law on the assumption that it is argumentative. They must express their reasoning clearly, motivate their judgments, and corroborate them with rational arguments in order for their partly subjective opinions to be amenable to subsequent interpretation and criticism.

C. Some Objections to Dworkin's Thesis: The Existence of a Single Right Answer Challenged

Many have denied that there is only one correct answer that must be reached by Hercules in each and every case. Dworkin divides his opponents in two classes: external and internal skeptics.[133] The internal skeptic agrees to play the game. He abides by the rules, searches for the right answer, and concludes, contrary to Dworkin, that there is no one right answer. In contrast, the external skeptic refuses to play the game. He claims to be able to step outside of it and to test the game as a whole against an external standard derived from some process other than ap-

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[130] *Id.* at 153-54, 169; *see* R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 226 (noting distinction to be drawn in this context between law as integrity and conventionalism or pragmatism).

[131] R. DWORKIN, A MATTER OF PRINCIPLE, *supra* note 5 at 140, 150. The phenomenon of "objectivizing" subjective beliefs is claimed by Fish to be rooted in wrong assumptions about the nature of language. *See* S. FISH, *supra* note 1; Fish, *Working on the Chain Gang: Interpretation in Law and Literature*, 60 TEX. L. REV. 551, 552-64 (1982); Fish, *Wrong Again*, 62 TEX. L. REV. 299, 305-06 (1983). His criticism is explored in more detail *infra* Section I.D.

[132] R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 88-89, 112.

[133] R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 78, 86, 230, 267, 373, 412; R. DWORKIN, A MATTER OF PRINCIPLE, *supra* note 5, at 173-77; R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 287.

peal to the rules of the game.[134] The external skeptic would conclude that there cannot be a right answer because the very attempt to classify propositions of law as right or wrong is absurd, for there is no such thing as objective right or wrong. Dworkin concludes that "[e]xternal skepticism is a metaphysical theory, not an interpretive or moral position."[135]

Dworkin denies that it is possible to step outside the game. He suggests that claims about morality are themselves moral claims.[136] In that sense, the claim that there is no objective right and wrong is self-defeating. "The theoretical argument . . . cannot even be stated, or so it seems, in a way that does not dissolve its claims into the very background it seeks to challenge."[137] Dworkin concludes that a skeptic's claim that the game is absurd must really be a claim made from within the game, an internally skeptical claim.[138]

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[134] R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 78-79; R. DWORKIN, A MATTER OF PRINCIPLE, *supra* note 5, at 173-77.

[135] R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 79.

[136] R. DWORKIN, A MATTER OF PRINCIPLE, *supra* note 5, at 171. For criticism noting Dworkin's refusal to acknowledge the metaphysical implications of his adjudicative model, see MacCormick, *supra* note 62, at 182; Woozley, *No Right Answer*, in RONALD DWORKIN AND CONTEMPORARY JURISPRUDENCE, *supra* note 62, at 173; Munzer, *Right Answers, Preexisting Rights and Fairness*, 11 GA. L. REV. 1055, 1056-65 (1977). These critics contend that the single right answer thesis is meaningless in, for example, a nihilistic metaphysical background. But it is unclear whether Dworkin truly denies that moral objectivity is a requirement of his thesis or whether he maintains the very different claim that it is impossible to defend moral objectivity rationally. *Compare* R. DWORKIN, A MATTER OF PRINCIPLE, *supra* note 5, at 144, 171-72 *with* R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 267, 373, 401-07. In any event, it is clear that, whichever position he adopts, Dworkin denies both the need and the possibility for human beings to engage in metaethical discourse. *See* R. DWORKIN, A MATTER OF PRINCIPLE, *supra* note 5, at 175-77. On this point, Fish agrees. "No one can be a relativist, because no one can achieve the distance from his own beliefs and assumptions which would result in their being no more authoritative for him than the beliefs and assumptions he himself used to hold." S. FISH, *supra* note 1, at 153. This agreement is, if not inconsistent, at least surprising, given Fish's relativist perspective of language.

[137] R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 290.

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> So there is no important difference in philosophical category or standing between the statement that slavery is wrong and the statement that there is a right answer to the question of slavery, namely that it is wrong. I cannot intelligibly hold the first opinion as a moral opinion without also holding the second. Since external skepticism offers no reason to retract or modify the former, it offers no reason to modify or retract the latter either. They are both state-

Internal skepticism may be manifested through the assertion of various objections, five of which will be examined in turn.[139] The most common objection raised against Dworkin's rights thesis is that Hercules does not exist because human judges are incapable of reaching the right answer. This objection does not, however, deny the possible existence of a right answer; it assumes its existence but claims that it is inaccessible. Dworkin does not assert, however, that judges reach the right answer in all hard cases. Rather, he claims only that an adjudicative method that aims at progressing toward the best answer is superior to a method that does not even tend toward this objective.[140] Moreover, in the same way that disagreement among jurists as to which of several competing answers is the right one does not eliminate the possibility that some of them are wrong, the inaccessibility of the right answer does not show conclusively that it does not exist.[141]

But the inaccessibility objection can be formulated differently, to imply that, to be considered true, a statement must be affirmatively demonstrated to be so. Because it proceeds through eliminating falsehood, the rights thesis would indeed be seriously undermined by the validity of such a proposition. But for this proposition to be acceptable as a standard, Dworkin replies, validity itself must be proven.[142] In the absence of such proof, there is no reason to accept it.

A third objection to the rights thesis is that it fits neither

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ments within rather than about the enterprise on morality.

R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 82; *see also* R. DWORKIN, A MATTER OF PRINCIPLE, *supra* note 5, at 172-73 (suggesting impossibility of disagreeing about, as opposed to within, morality).

[139] The decision to discuss only five objections does not imply that other possible objections are uninteresting. These objections were selected on the dual basis that they are relevant for present purposes and that they are more likely to be widely shared by scholars. Among other possible objections to the rights thesis are those arguments based on vagueness, R. DWORKIN, A MATTER OF PRINCIPLE, *supra* note 5, at 128-31; the argument that institutional materials are inherently contradictory, R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 268-69; and some arguments of deductive logic about the concept of truth, R. DWORKIN, A MATTER OF PRINCIPLE, *supra* note 5, at 122-27, 136-37.

[140] R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 130, 280.

[141] R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 264; R. DWORKIN, A MATTER OF PRINCIPLE, *supra* note 5, at 120, 143.

[142] R. DWORKIN, A MATTER OF PRINCIPLE, *supra* note 5, at 137-41.

current legal practice nor popular perceptions of law.[143] Dworkin offers two alternative answers to this criticism. First, he rebuts the criticism by asserting that lawyers always argue as if there were only one right answer, rather than a set of acceptable ones, in the disposition of all cases.[144] Similarly, judges generally feel they reach what they consider to be the imperative conclusion in each and every judicial instance.[145] Moreover, these conclusions are judged as right or wrong by laymen. Second, in the event that the rights thesis is not in fact true to judicial practice, Dworkin responds that the thesis is normative as well as descriptive, and hence it falls on judicial practice to conform to the Herculean model.[146] In other words, "[t]he law may not be a seamless web; but the plaintiff is entitled to ask Hercules to treat it as if it were."[147]

The fourth objection to the rights thesis concerns the interplay between objective institutional materials and their subjective comprehension by judges. Some might argue that objectivity and subjectivity are not sufficiently disconnected in the process to act as checks and balances on each other in the way described by Dworkin.[148] This would constitute a serious threat to the rights thesis. Dworkin refuses, however, to consider this criticism unless, once again, it is demonstrated as providing the best picture of the interplay between objectivity and subjectivity.[149]

Last, but not least, some have denied the very existence of objective constraints generated by institutional materials. According to Fish, words are devoid of objective meaning.[150] Instead, they are mere symbols that are entirely meaningless outside the cognitive interpretative process. Since words become

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[143] *Id.* at 167.

[144] *Id.*

[145] *Id.*

[146] R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 110-12, 264; R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 300, 312.

[147] R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 116. Elsewhere, Dworkin explains, "The proposition that there is some 'right' answer to that question does not mean that the rules of chess are exhaustive and unambiguous; rather it is a complex statement about the responsibilities of its officials and participants." *Id.* at 104.

[148] R. DWORKIN, A MATTER OF PRINCIPLE, *supra* note 5, at 175.

[149] R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 236-37.

[150] S. FISH, *supra* note 1, at 109.

intelligible only when they are subjectively interpreted, all interpretations are equivalent in value; no one is superior to another.[151] Communication is established when two individuals share a subjective interpretation of a given symbol. In that case, these individuals are said to belong to the same "interpretive community."

Dworkin's reply to Fish is no different from his answer to previous objections: Fish's conception of "interpretive community" is no more than one theory of language among many. Therefore, he has "to make a genuine argument to [the] effect [that any text allows any interpretation whatsoever] by setting out some appealing normative theory of artistic integrity that has that consequence."[152]

II. Popper's Model of Scientific Reasoning

Since Descartes,[153] Hobbes,[154] Locke,[155] and Hume,[156] scientific knowledge has been defined as a particularly reliable kind of human belief.[157] Breaking with this subjectivist tradition, Karl Popper offers the alternative of an objective theory of knowledge.

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[151] *Id.* Hirsch divides the concept of word into "meaning" and "significance," the latter being the subjective interpretation of the former, objective component. E. Hirsch, The Aims of Interpretation 1-13 (1976).

[152] R. Dworkin, A Matter of Principle, *supra* note 5, at 172, 176; *see* R. Dworkin, Law's Empire, *supra* note 6, at 77, 261; R. Dworkin, Taking Rights Seriously, *supra* note 4, at 81.

In addition to Dworkin's defensive reply, one could think of an aggressive response to the interpretive community thesis. First, the thesis offers no mechanism to identify the boundaries of each one of these linguistic communities. Second, it is not clear at all that such a mechanism exists.

[153] R. Descartes, Discourse on Method and Meditations on First Philosphy (1980).

[154] T. Hobbes, Human Nature: Or the Fundamental Elements of Policy, in Body, Man and Citizen 182-83 (1967).

[155] J. Locke, *Essay Concerning Human Understanding*, in The Works of John Locke (1885).

[156] D. Hume, Enquiry Concerning Human Understanding (1927); D. Hume, Treatise on Human Nature (1888).

[157] K. Popper, Objective Knowledge, *supra* note 8, at vii (1972); *see* F. Hayek, Law, Legislation and Liberty: A New Statement of the Liberal Principles of Justice and Political Economy, 9-14 (1973).

A. *Science as Interpretation*

Popper rejects the subjectivist account of scientific discovery as one aimed at demonstrating positively that certain theories are true. Instead, the Popperian model of discovery proceeds negatively; although truth is the regulative idea, it cannot be grasped directly and must therefore be ascertained indirectly through elimination of falsehood.[158] Popper explains:

> The fundamental difference between my approach and the approach for which I long ago introduced the label "inductivist" is that I lay stress on negative arguments, such as negative instances or counter-examples, refutations, and attempted refutations—in short, criticism—while the inductivist lays stress on "positive instances," from which he draws "non-demonstrative inferences," and which he hopes will guarantee the "reliability" of the conclusions of these inferences. In my view, all that can possibly be "positive" in our scientific knowledge is positive only in so far as certain theories are, at a certain moment of time, preferred to others in the light of our critical discussion which consists of attempted refutations, including empirical tests. Thus even what may be called "positive" is so only with respect to negative methods.[159]

This negative process comprises several distinct stages. Any discovery starts with the subjective identification of the problems to be studied, or the explicandum.[160] Some problems demand an explanation, or an explicans, that is not amenable to refutation and that does not, as a result, qualify as a "scientific" explanation. Amenability to refutation is adopted by Popper as the "demarcation" criterion to sort out scientific from non-scientific explicantia.[161] This is not to say that non-scientific state-

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[158] K. Popper, The Logic of Scientific Discovery 275, 280 (1972); K. Popper, Objective Knowledge, *supra* note 157, at 318.

[159] K. Popper, Objective Knowledge, *supra* note 8, at 20.

[160] *See id.* at 167, 191-93.

[161] *Id.* at 12 n.19.

> The "problem of demarcation" is what I call the problem of finding a criterion by which we can distinguish the statements of empirical science from non-empirical if there are (finite) conjunctions of singular empirical statements ("basic statements," or "test statements") which contradict it. It is a consequence of this "principle of demarcation" that an isolated purely existential statement

ments are meaningless; indeed, Popper has suggested that the scientific method is applicable in other fields. The criteria defining an admissible explicans may vary from field to field.[162]

In the second stage of the elimination process, the scientist undertakes to set out various possible explanations that solve the problem. All explanations are conjectural or hypothetical theories; they cannot be generated through purely logical, deductive reasoning. Rather, they may require subjective imagination and human ingenuity.[163]

The various conjectures which are not worth testing will be put aside, at least for the time being. Popper describes a conjecture that is worth testing as one that displays high explanatory power, one that is "bold,"[164] "universal,"[165] and "improbable."[166] A theory has a high explanatory power when its content is rich and highly informative and it would prove, if unrefuted, a valuable contribution to scientific knowledge.[167] High explanatory power is a function of two variables, generality and precision, which can be simultaneously present. It is general when susceptible of application to a wide range of explicanda; it is precise when it confers much information about each one of the explicanda under study. However, high explanatory power entails a greater vulnerability to refutation. As a result, theories worth testing are "bolder,"[168] or, stated differently, are more "improba-

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(such as "There exists a seaeserpent somewhere in the world at some time") is not an empirical statement.

Id.; *see also id.* at 30 (application of critical approach).

[162] K. POPPER, CONJECTURES AND REFUTATIONS 193 (1969).

[163] K. POPPER, OBJECTIVE KNOWLEDGE, *supra* note 8, at 202.

As discussed *infra*, Popper's elimination process does not require that the theories (T_1) used to criticize other theories (T_2) be demonstrated as true in order for their criticism to be valid. Therefore, the conjectural character of T_1 is no threat to the success of the enterprise of testing T_2. K. POPPER, OBJECTIVE KNOWLEDGE, *supra* note 8, at 34-35.

[164] *See infra* note 168.

[165] K. POPPER, OBJECTIVE KNOWLEDGE, *supra* note 8, at 196-97.

[166] K. POPPER, CONJECTURES AND REFUTATIONS, *supra* note 162, at 58.

[167] K. POPPER, THE LOGIC OF SCIENTIFIC DISCOVERY, *supra* note 158, at 83; K. POPPER, OBJECTIVE KNOWLEDGE, *supra* note 8, at 55, 143-44, 193, 264. Tautological statements are examples of true statements that display no explanatory power whatsoever. *Id.* at 41.

[168] "A theory is the bolder the greater its content. It is also the riskier: it is the more probable to start with that it will be false." K. POPPER, OBJECTIVE KNOWLEDGE, *supra* note 8, at 53.

ble" and less likely to survive testing[169] than theories with low explanatory power. Similarly, universal theories that are applicable to a variety of explicanda exhibit superior explanatory power and are more vulnerable to refutation than "ad hoc" theories not amenable to independent testing.[170]

Once bold theories have been singled out, they are submitted to testing. As the heart of the elimination process, this third stage is crucial. The scientist will attempt to refute all but one theory, which will be considered most valuable and closest to the truth until further testing.[171] For that purpose, the scientist needs a methodology and a theory of truth. As the "organon of criticism,"[172] deductive logic provides the methodology conducive to rational criticism.[173] With respect to a theory of truth, various ones are available for that purpose. Coherence with the body of previous theories is one; correspondence with the facts is another,[174] the latter being that adopted by Popper.[175]

Each theory is subjected to falsification by testing it against what Popper calls "basic-statements" or "test-statements." Basic statements are statements concerning reality "about which the various investigators are likely to reach agreement."[176] In the same way that theories are not proven true but merely proven

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[169] *Id.* at 48; K. POPPER, CONJECTURES AND REFUTATIONS, *supra* note 162, at 58.

[170] K. POPPER, OBJECTIVE KNOWLEDGE, *supra* note 8, at 192.

[171] *Id.* at 15.

[172] *Id.* at 121, 318.

[173] *Id.* at 12, 30-31. It is the availability of rational criticism that distinguishes human beings from other living organisms. Whereas the elimination of error by human beings is achieved by critically discarding false theories before they affect us, error is usually fatal for other living organisms that are unable to prevent the damage before it occurs. *Id.* at 261.

[174] Popper mentions another possible theory of truth, the theory of pragmatic utility, which he rejects. *See id.* at 309. According to that criterion, "we should accept a physical theory as true if it turns out in tests, and other applications, to be pragmatically useful, or successful." *Id.* This third criterion is not relevant to the enterprise of drawing parallels between the Dworkinian and Popperian models, since it is rejected in both.

[175] According to Popper, the correspondence theory of truth was salvaged by Tarski's concept of "metalanguage." K. POPPER, CONJECTURES AND REFUTATIONS, *supra* note 162, at 223-28 (real significance of Tarski's concept is that it illustrates freedom to use intuitive ideas of truth as correspondent with facts); K. POPPER, OBJECTIVE KNOWLEDGE, *supra* note 8, at 308 (statement is true only if it corresponds with recognized facts); *see also* A. TARSKI, LOGIC, SEMANTICS, METAMATHEMATICS 152-278 (1956).

[176] K. POPPER, THE LOGIC OF SCIENTIFIC DISCOVERY, *supra* note 158, at 104.

not false, basic statements cannot be demonstrated to be objectively true. In fact, their validity may well be challenged, and they, in turn, may be subjected to further tests.[177] As Popper explains, "this procedure has no natural end."[178] The distinction between the theory under test and the basic statements used in the testing is one of degree; basic statements are theories that are especially easy to test. Indeed, for the testing of theories to be workable and fruitful, it is necessary that scientists stop "at some point or other and say that [they] are satisfied, for the time being."[179]

Scientists will stop at a point where they can reach intersubjective agreement about some state of affairs. As a basic proposition, we have a statement that something is the case; this statement holds the status of mere interpretation, for, like all interpretations, it is falsifiable.[180] The basic statement will come with a statement of a low-level principle concerning how the state of affairs in question can be generated. It is, in principle, open to people to question an accepted basic statement on that basis and to propose a revised verdict.[181] Ideally, unless they can plausibly explain it away simply as the result of a mistake, those who come to a revised view hope to be able to explain how it was that the previous, incorrect basic statement was accepted as an account of what they now view as the correct state of affairs.

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[177] Popper concludes:

> The empirical basis of objective science has thus nothing "absolute" about it. Science does not rest upon solid bedrock. The bold structure of its theories rises, as it were, above a swamp. It is like a building erected on piles. The piles are driven down from above into the swamp, but not down to any natural or "given" base; and if we stop driving the piles deeper, it is not because we have reached firm ground. We simply stop when we are satisfied that the piles are firm enough to carry the structure, at least for the time being.

Id. at 111.

[178] *Id.* at 104.

[178] *Id.*

[180] Popper gives the example of the judicial procedure that combines judge and jury to illustrate basic statements. In trials with a jury, the judge is in charge of applying a theory or legal rule. His selection of the appropriate rule, or his construction of a new one, will be based on the facts as agreed upon by the jury, or basic statements. The interpretation of the facts by the jury is not and need not be unquestionably right. But for the purpose of the trial, it has been decided, as a matter of procedure, to stop at the jury's verdict and to consider it as valid. *Id.* at 109-10.

[181] *Id.*

In short, when some occurrences ruled out by a certain theory do in fact occur, we will conclude that, assuming our basic statements are correct, the theory is incorrect.[182] But theories may be incorrect in variable degrees. A new theory is superior to an old one if it solves all problems solved by the old one as well as problems previously unsolved, and if it is closer to the truth than the old one.[183] In other words:

> We cannot attribute truth . . . to our theories [in the sense of knowing that we have attained it]. The use of such standards as truth, and approximation to the truth, plays a role only within our criticism. We may reject a theory as untrue, and we may reject a theory as being less close an approximation to truth than one of its predecessors, or competitors.[184]

As a result, when two theories are inconsistent, one or both of them must be discarded, for both cannot equally correspond to the facts.[185] Can the scientist be overly critical in his attempts at refutation? Surely. But being overly critical is no threat to the success of the enterprise, for counter-criticism is always possible.[186]

The theory that offers the best solution is isolated and considered as closest to the truth until subsequent superior theories arise to dethrone it.[187] Since the number of possible superior theories is infinite, the superiority of the best theory is never

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[182] *Id.* at 88.

[183] K. POPPER, OBJECTIVE KNOWLEDGE, *supra* note 8, at 56-57; *see id.* at 15, 202. Popper calls approximation to the truth "verisimilitude." In this sense, despite the falsity of two theories, one of them may be closer to the truth, or less false, than the other because of the one's greater verisimilitude. *Id.* at 52, 56; *see* K. POPPER, CONJECTURES AND REFUTATIONS, *supra* note 162, at 228.

[184] K. POPPER, OBJECTIVE KNOWLEDGE, *supra* note 8, at 265.

[185] *Id.* at 311.

[186] *Id.* at 305.

[187] K. POPPER, THE LOGIC OF SCIENTIFIC DISCOVERY, *supra* note 158, at 108.

> The preference is certainly not due to anything like an experiential justification of the statements composing the theory; it is not due to a logical reduction of the theory to experience. We choose the theory which best holds its own in competition with other theories; the one which, by natural selection, proves itself the fittest to survive.

Id.; *see also* K. POPPER, OBJECTIVE KNOWLEDGE, *supra* note 8, at 261 ("natural selection" is process by which hypothesis shows fitness by surviving competition against other hypotheses).

certain.[188] As a result, a theory can never be taken as established; at best, it is temporarily preferred. This preference is based on a hope that this particular theory is most promising in view of further testing and that it may also be true.[189] Once the preferred theory is identified, the scientist will try to replace it with another theory that represents an advance in terms of universality and precision.[190] But once again, the more universal and precise a theory, the more vulnerable to refutation it becomes. Thus the quest for truth is an endless process of refutation.

Popper illustrates this three-step elimination process by the following formula:

$$P_1 \text{ —> } TT \text{ —> } EE \text{ —> } P_2$$[191]

P_1 corresponds to the first stage at which the problem to be solved, the explicandum, is identified. The development of various theories to solve P_1 occurs at the second stage, TT. The error elimination process of the third stage is represented by EE. The resulting P_2 indicates that the solution to P_1 will itself be submitted to further elimination.

This formula suggests that the search for the truth is never complete.[192] Progress is not assured, since it is possible that theories may be refuted without developing alternatives to replace them.[193] Nevertheless, eliminating falsehood is, according to Popper, the only way to progress towards the truth.[194] He

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[188] K. POPPER, OBJECTIVE KNOWLEDGE, *supra* note 8, at 15-16.

[189] *Id.* at 13. Popper illustrates the fleeting character of true theories by giving the example of the substitution of Einstein's law of gravity for that of Newton. *See id.* at 9.

[190] *Id.* at 193.

[191] *See id.* at 121, 164, 242, 287.

[192] *See id.* at 298; K. POPPER, CONJECTURES AND REFUTATIONS, *supra* note 162, at 222 (new theories proposed as solutions to existing problems contribute to infinite growth of scientific knowledge by raising new, unanswered problems).

[193] K. POPPER, OBJECTIVE KNOWLEDGE, *supra* note 8, at 17, 203-04.

[194] In affirming the exclusivity of this option, Popper claims to have solved the problem of induction evoked by Hume, *supra* note 156, at 91-139, which may be summarized as follows:

(1) There is no rational justification for reasoning from repeated instances to other instances or probability of instances of which there is no experience, however great the extent of repetition. K. POPPER, OBJECTIVE KNOWLEDGE, *supra* note 8, at 4, 86-90.

(2) Nevertheless, human beings infer from the repetition of past experiences that

concludes:

> [W]hile we can never have sufficiently good arguments in the empirical sciences for claiming that we have actually reached the truth, we can have strong and reasonably good arguments for claiming that we may have made progress towards the truth . . . .[195]
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> . . . .
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> . . . . [T]he growth of all knowledge consists in the modification of previous knowledge — either its alteration or its large-scale rejection.[196]

B. Objectivity in Science: "Knowledge Without a Knowing Subject"

The elimination process described in the previous section requires that knowledge be at least partially objective. Indeed, elimination is doomed to failure if no external standard exists with which to compare the theories.[197]

According to subjectivists, knowledge results from the passive accumulation of data perceived through our senses[198] and is thus exclusively internal to the knowing subject, leaving no room

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they will be repeated in the future.

(3) Therefore, human beings are irrational. *Id.* at 5, 90. The troubling corollary, according to Hume, is that, since the lunatic's judgment becomes as valuable as that of the scientist, "sensualistic empiricism [is driven] into an absurd idealism." *Id.* at 87.

Popper disputes the validity of Hume's major premise as follows:

(1) Preferences for non-false theories are rationally justified. (2) Despite its failure to positively demonstrate the truth of certain theories, empiricism can serve to prove their falsity. (3) Therefore, preferences grounded in empiricism are rational. *Id.* at 6-8.

It follows that, since the lunatic's judgment will remain as valuable as that of the scientist only as long as it is not proven, empiricism is rescued from absurdity; and human beings, from irrationality. Whereas the theoreticians asserting that certain theories are doubtlessly true would indeed be irrational, the practical man is rationally justified in relying upon unrefuted theories as the best available ground for action. *Id.* at 21-22, 95; K. POPPER, CONJECTURES AND REFUTATIONS, *supra* note 162, at 51.

[195] K. POPPER, OBJECTIVE KNOWLEDGE, *supra* note 8, at 57-58.

[196] *Id.* at 71. In more poetic terms, "[W]e are workers who are adding to the growth of objective knowledge as masons work on a cathedral." *Id.* at 121.

[197] K. POPPER, CONJECTURES AND REFUTATIONS, *supra* note 162, at 117.

[198] *See* G. HEGEL, THE PHENOMENOLOGY OF MIND 149-60 (J. Baillie trans. Torchbook ed. 1967); J. LOCKE, *supra* note 155; K. MARX, THE ECONOMIC AND PHILOSOPHIC MANUSCRIPTS OF 1844 (1964).

for error. This "bucket theory of knowledge," or "*tabula rasa* theory of the mind," is also adopted by behaviorists.[199] In contrast, Popper claims that knowledge comprises subjective and objective components. The knowing subject plays a necessary, but incomplete, role in the evolution of knowledge.[200] He possesses innate dispositions that allow him to decode data entering his senses.[201] Since dispositions vary from one knowing subject to another, decoding is indeed subjective.[202] But decoding generates beliefs that lead to the subsequent formulation of theories or explanations for the facts observed. When internal beliefs are externalized through expression, they become objective.[203] Popper suggests we think of there being three "worlds."[204] Physical facts belong to the "first world." Subjective experiences, dispositions and beliefs constitute the "second world." The "third world" contains theories, arguments, problems, and other objective formulations of the second world.[205]

Objective knowledge evolves out of the interaction between the three worlds.[206] The second world acts as an intermediary between the first and third worlds; testing third world theories requires the knowing subject to observe the first world.[207] His subjective decoding of factual data provides the basis for correc-

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[199] K. POPPER, OBJECTIVE KNOWLEDGE, *supra* note 8, at 61-62; *see* K. POPPER, CONJECTURES AND REFUTATIONS, *supra* note 162, at 28 (knowledge starts from more than *tabula rasa*).

[200] K. POPPER, OBJECTIVE KNOWLEDGE, *supra* note 8, at 73.

[201] *Id.* at 64; *see* K. POPPER, THE LOGIC OF SCIENTIFIC DISCOVERY, *supra* note 158, at 99 (knowledge may be linked with feelings of belief or conviction).

[202] K. POPPER, OBJECTIVE KNOWLEDGE, *supra* note 8, at 71.

[203] *Id.* at 25. "Only objective knowledge is criticizable: subjective knowledge becomes criticizable only when it becomes objective. And it becomes objective when we say what we think; and even more so when we write it down, or print it." *Id.* at 25; *see also id.* at 120 (describing objective and subjective senses of knowledge).

[204] *Id.* at 74; *see id.* at 106 (describing distinguishing characteristics of three worlds); *see also id.* at 112 (illustrating three theories of third world attributes).

[205] *Id.* at 106. Popper's third world differs from Plato's in that it is not of divine origin, but rather resembles Frege's. *Id.* at 127. At this point, Popper draws an analogy between epistemology and biology to reinforce the idea of an autonomous third world. *Id.* at 112-15. He gives the example of the acknowledged distinction between organisms' acts of production and their actual products, such as the spider's weaving and the woven web. *Id.* at 113.

[206] *Id.* at 111-12.

[207] *Id.* at 155.

tion and improvement of third world theories.[208] Despite the objectivity of the first world, however, the knowing subject's perception of it is not impartial. It is influenced by the theory under test. Unconsciously, the knowing subject will perceive only those data that appear relevant to the current purpose.[209] Conversely, imperfect decoding will be corrected by appeal to the third world.[210] Both objective knowledge and the knowing subject's subjective dispositions will evolve out of the mutual checks and balances of their interaction.[211]

However, interaction is possible only between elements that are distinct from one another. Popper's "principle of emergence" corroborates the autonomy of the third world, which is central to the evolutionary thesis. This principle describes the phenomenon whereby problems of the third world may generate further problems that were not initially expected by the knowing subject.[212] Similarly, "the person who produces a theory may very often not understand it."[213] Such phenomena could not occur if all knowledge were strictly dependent upon the knowing subject. The autonomy of the third world can be further explained by appeal to the concept of potentiality.[214] In the same way that a bird's nest is a potential home even when not actually inhabited, theories exist outside the minds of knowing subjects. Theories are potential objects of criticism. As a result, thoughts are dis-

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[208] *Id.* at 258. It is thus misleading to suppose that observation precedes theory entirely. *Id.*

[209] *Id.* at 72. Once again Popper relies on biological analogies: "[W]hat can be absorbed (and reacted to) as relevant input and what is ignored as irrelevant depends completely upon the innate structure (the 'programme') of the organism." *Id.*; *see also, e.g.*, *id.* at 70, 145 (describing biological development as product of trial and error method); K. POPPER, THE LOGIC OF SCIENTIFIC DISCOVERY, *supra* note 158, at 106-07 (explaining epistemological theory of experiment).

[210] K. POPPER, OBJECTIVE KNOWLEDGE, *supra* note 8, at 112. Were it otherwise, explains Popper, this evolution would be impossible. "[I]f anybody were to start where Adam started, he would not get further than Adam did." *Id.* at 122.

[211] *Id.* at 249. Popper compares this checks-and-balances interaction to soap bubbles; the malleable soap film controls and is shaped by the air it contains. *Id.* Stated differently, these interacting organisms are "clouds controlled by clouds." *Id.* at 245.

[212] *Id.* at 119; *see id.* at 146 (life cyclical progression from old problems to new ones); *see also id.* at 288 (explaining creation of new problems out of solutions to old problems).

[213] *Id.* at 299.

[214] *Id.* at 289-95.

tinct from the thought process that generated them.[215]

Given the dissociation between the second and third worlds, error is possible. Indeed, the subjective decoding of objective data is fallible; it may not always reflect reality perfectly.[216] The formulation of theories will permit correction of mistaken decoding. Popper characterizes the descriptive and argumentative functions of language as corrective tools that are exclusively human.[217] Whereas animals must die from their decoding mistakes, human beings may be rescued by their capacity to criticize and repair.[218] In order for such a process to take place, however, the formulation of theories is of prime importance, for unformulated theories are immune to criticism. The validity of human beliefs is therefore secondary. What really counts is that these beliefs must be formulated, for then their validity can be evaluated, criticized, and improved. "As long as we are critically inclined, it does not matter much where or how we start."[219]

III. Dworkin's Model Revisited

In this third part, parallels are drawn between Dworkin's model of legal reasoning and Popper's account of scientific reasoning. Inconsistencies in the Dworkinian model are then outlined, and corrections are offered. Finally, an example of adjudication proceeding on the basis of the corrected Dworkinian model is given.

A. Similarities Between Dworkin's and Popper's Models

1. Law as Interpretation

As presented in the previous two parts, both Dworkin and Popper denounce the myth of a dichotomy between discovery and interpretation, asserting instead that the latter pervades the former in all cases. This myth of neutrality originates from Roman law, where *interpretatio* has two different meanings.[220] The

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[215] *Id.* at 289.

[216] *Id.* at 121.

[217] *Id.* at 236-39; *see id.* at 121 (human dependency on language).

[218] *Id.* at 238.

[219] *Id.* at 72.

[220] Schiller, *Roman Interpretatio and Anglo-American Interpretation and Con-*

first is broad and allies itself with our modern notion of "interpretation." It denotes "the entire influence of the jurists upon the development of the law, in other words, all of the processes that led to the formation of new law except that of legislation."[221] The second is narrow and refers to the jurists' activity of *respondere*, which consists of applying the letter of the law without further inquiry into its deeper scope.[222] This second form of *interpretation* corresponds to our notion of "literal" or "genuine" interpretation. According to the Latin maxim *clara non sunt interpretanda*, only when the word of the law is unclear should jurists interpret it in the wide sense.

This clear-cut distinction between clear and unclear canons was later maintained in the positivist tradition. According to Austin, judges may look at the scope of the law, the *ratio legis*, or legislative intent, only when the words are unclear.[223] In cases where the letter of the law is unambiguous, appeal to the *ratio legis* becomes spurious interpretation.[224]

Despite its survival in scattered legislative texts,[225] this distinction is now largely denounced by legal scholars and philosophers.[226] Since Kant,[227] it is widely acknowledged that no word

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struction, 27 VA. L. REV. 733 *passim* (1941).

[221] *Id.* at 735.

[222] *Id.*

[223] J. AUSTIN, LECTURES IN JURISPRUDENCE 318-20 (1977); *see also* E. CLARK, PRACTICAL JURISPRUDENCE 227-46 (1980); F. LIEBER, LEGAL AND POLITICAL HERMENEUTICS 55-82 (1970); Pound, *Spurious Interpretation*, 7 COLUM. L. REV. 379, 381 (1907) (goal of genuine interpretation to determine rule sought by lawmaker).

[224] J. AUSTIN, *supra* note 223, at 318-20.

[225] *See, e.g.*, section 1013 of the Lower Canada Civil Code: "When the meaning of the parties in a contract is doubtful, their common intention must be determined by interpretation rather than by an adherence to the literal meaning of the words of the contract." LOWER CANADA CIVIL CODE § 1013; *see also* CODE NAPOLEON § 1156; and LA. CODE ANN. art. 1945 (West 1987).

[226] Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 458 (1897) (explaining interconnection in legal system); McIntosh, *Legal Hermeneutics: A Philosophical Critique*, 35 OKLA. L. REV. 1, 8 (1982) (rendering of meaning through interprétation); Pérelman, *L' interprétation juridique*, 17 ARCHIVES DE PHILOSOPHIE DU DROIT 29, 30 (1972). *But see* B. CARDOZO, THE NATURE OF JUDICIAL PROCESS 129 (1971) (judge's lack of discretion under unmistakable mandate of statute).

[227] Kant divided the communication process into two components: the noumenon and the phenomenon. In his view, only the latter would be accessible to the human mind. I. KANT, THE CRITIQUE OF PURE REASON (1963).

makes sense to the human mind without interpretation. Indeed, Willis wrote of *Ellerman Lines v. Murray*[228] that "all the judges were agreed that the meaning was 'plain,' but there were at least three different views as to what that 'plain meaning' was."[229] Moreover, even if the dichotomy were tenable, the fact that it falls to the judge to determine which words are clear and which ones are not, and thus, when he must interpret and when he must refrain from interpreting, seriously undermines the neutrality of the process. This is so even when a term is ultimately found to be clear.

Dworkin would embrace Popper's assertion that any understanding involves a certain degree of subjectivity, thereby rejecting historicism as well as the distinctions between interpretivism/noninterpretivism and activism/passivism in constitutional adjudication.[230] His rejection of these distinctions is sound and is shared by many scholars. The neutrality of historicism has been contested as unrealistic.[231] Similarly, noninterpretivism is called into question as a mere fiction to salvage the judiciary's democratic legitimacy. As to passivism, its proponents cannot claim that abstention is the way for judges to remain neutral when constitutional provisions are unclear.[232]

2. Interpretation in Law

Like Popper's method of scientific discovery, Dworkin's model of adjudication[233] is centered on error elimination rather

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[228] 1931 A.C. 126.

[229] Willis, *Statute Interpretation in a Nutshell*, 16 CAN. B. REV. 1, 11 (1938); *see also* Croxford v. Universal Ins. Co., [1936] 2 K.B. 253, 280.

[230] *See supra* notes 122-25 and accompanying text.

[231] *See* HIRSCH, *supra* note 151.

[232] MILLER & HOWELL, *The Myth of Neutrality in Constitutional Adjudication*, 27 U. CHI. L. REV. 661, 663-64, 676-78, 783-93 (1960); Wechsler, *The Nature of Judicial Reasoning*, in LAW AND PHILOSOPHY 293 (S. Hook ed. 1964).

[233] It is important to emphasize here the distinction between a model of adjudication and a theory of the source of legal rules. The evolutionary model presented in this article is of the former kind; it is assumed that objective standards exist somewhere and that the method by which positive law will gradually be made to reflect these standards is evolutionary. It is not suggested, as Hayek has urged, that the content of the standards is created through legal Darwinism. *See supra* note 157. Should the evolutionary process attach to the creation rather than to the mere discovery of these standards, the present model would necessarily lead to cultural relativism. *See infra* Section III.B.

than on a direct quest for the right answer. It proceeds from a preinterpretive stage of problem identification, to the development of possible and valuable legal rules, the elimination through criticism of most of them, and, finally, the isolation of the "best" rule. This process is never completed, for the "best" rule is likely to be dethroned once further testing is undertaken. Through refutation and error elimination, legal rules are refined, modified, improved, or straightforwardly discarded. The expected result is the constant improvement of our legal system.

Dworkin contends that the rights thesis is both descriptive and normative.[234] On the one hand, the Dworkinian model is a plea for the judiciary to improve our legal system. In addition, it accurately reflects what actually takes place in judicial reasoning. Although the process may not always be precisely dissected, the interpretive stages always succeed one another. Sometimes the process is clearly spelled out; at other times it is spontaneous.

A concrete example may prove useful to visualize the process of rule formation through elimination in the legal context. In 1842, the English House of Lords formulated the rule that a contractual relationship between a plaintiff and defendant was necessary for the plaintiff to have a cause of action in tort.[235] A century later, a new case arose that involved parties without a contractual relationship.[236] Despite the binding force of the 1842 precedent, the House of Lords decided in *Donoghue v. Stevenson*[237] that corrective justice demanded that the action be allowed, and it disposed of the case in a way that was later interpreted as overruling its previous decision.[238] From then on, the

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[234] R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at vii.

[235] Winterbottom v. Wright, 152 Eng. Rep. 402 (Ex. 1842).

[236] M'Alister (Donoghue) v. Stevenson, 1932 A.C. 562 (Scot).

[237] *Id.* "The liability for negligence, whether you style it such or treat it as in other systems as a species of 'culpa,' is no doubt based upon a general public sentiment of moral wrongdoing for which the offender must pay." *Id.* at 580 (Atkin, L.J.).

[238] *Id.* at 562. Indeed, in almost all subsequent decisions involving tort actions, courts have begun their analyses of precedents with *Donoghue*. *See, e.g.*, Deyong v. Shenburn, 1946 K.B. 227, 229 (C.A.) (citing rule laid down in *Donoghue*); Clay v. A. J. Crump & Sons, [1964] 1 Q.B. 533, 539 (C.A.) (noting *Donoghue* does not apply to land cases); Watson v. Buckley and Osborne, Garrett and Co., [1940] 1 All E.R. 174, 175 (K.B.) (extending *Donoghue* doctrine to distributors of goods); Home Office v. Dorset

rule would be:

> You must take reasonable care to avoid acts or omissions which you can reasonably foresee would be likely to injure your neighbour. . . . [that is,] persons who are so closely and directly affected by my act that I ought reasonably to have them in contemplation as being so affected when I am directing my mind to the acts or omissions which are called into question.[239]

The new rule was a real improvement over the old one, but it was too broad. According to that rule, negligent misrepresentations could be sufficient ground for third parties to sue for damages suffered in reliance upon such representations. In *Candler v. Crane, Christmas & Co.*,[240] the Court of Appeal registered its concern that such an outcome was undesirable on several grounds. One of them was that it would generate injustice.[241] Another was that it could not have been the intention of Lord Atkin, speaking for the majority in *Donoghue*, that such cases of negligent misrepresentation be covered by the rule so enunciated.[242] As a result, the court held that the general rule

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Yacht, [1970] 2 All E.R. 294, 294 (H.L.)(referring to *Donoghue* duty of care); Junior Books Ltd. v. Veitchi Co., [1982] 3 All E.R. 201, 201 (H.L.) (ruling on applicable duty of care in negligence action).

[239] *Donoghue*, 1932 A.C. at 580 (Atkin, L.J.).

[240] [1951] 2 K.B. 164 (C.A.)

[241] *Id.*

> Singular consequences would follow if the principle laid down in [*Donoghue*] were applied to negligent misrepresentation in every case in which the representee were proximate to the representor. The case has been instanced . . . of a marine hydrographer who carelessly omits to indicate on his map the existence of a reef. The captain of the 'Queen Mary,' in reliance on the map and having no opportunity of checking it by reference to any other map, steers her on the unsuspected rocks, and she becomes a total loss. Is the unfortunate cartographer to be liable to her owners in negligence for some millions of pounds damages?

Id. at 194 (Asquith, L.J.). It should be noted that Lord Asquith's statement is not, at least at this point, necessarily incompatible with Dworkin's model. Indeed, Dworkin could well interpret Lord Asquith's concern for justice as an appeal to political morality.

[242] *Id.* at 189. Lord Asquith discusses the rule formulated by Lord Atkin in *Donoghue*:

> This passage, if read literally and without regard to the qualifying effect of its context or of the "subjecta materies," might be taken to comprehend not only conduct causing physical injury to person or property through setting a certain kind of chattel in motion or in circulation . . . but also conduct of any kind,

of *Donoghue* called for a narrower interpretation and refused to hold an accounting firm responsible for the damage suffered by an investor who relied on the accountants' financial statements.[243] *Donoghue* was to be restricted to cases involving physical damage; pure economic loss could not be recovered.

In dissent, Lord Denning expressed the opinion that the distinction between physical and pure economic loss was irrational.[244] Instead, he proposed a detailed test whereby *Donoghue* would retain a limited application in cases of negligent misrepresentation. An action in tort could be maintained:

> [Against] those persons such as accountants, surveyors, valuers and analysts, whose profession and occupation it is to examine books, accounts, and other things, and to make reports on which other people —other than their clients— rely in the ordinary course of business. . . .
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> . . . .
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> [B]y any third person to whom they themselves show the accounts, or to whom they know their employer is going to show the accounts, so as to induce him to invest money or take some other action on them. . . .[245]

Thirteen years later, in *Hedley Byrne & Co. v. Heller*,[246] the House of Lords endorsed Lord Denning's view and suggested it would have awarded compensation for economic damages suffered by the plaintiff if it had not been for an express disclaimer protecting the defendant in the case.[247] The authority of *Hedley*

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through any means (including negligent misstatement) causing damnum of any kind recognized by the law, whether physical or not, to anyone who could bring himself within Lord Atkin's definition of a "neighbour." I cannot believe so broad an application was intended by Lord Atkin himself.

Id.

[243] *Id.* at 193.

[244] *Id.* at 179 (Denning, L.J.).

I cannot accept this as a valid distinction. I can understand that in some cases of financial loss there may not be a sufficiently proximate relationship to give rise to a duty of care; but, if once the duty exists, I cannot think that liability depends on the nature of the damage.

Id.

[245] *Id.* at 179-80.

[246] 1964 A.C. 465 (1963).

[247] *Hedley Byrne*, 1964 A.C. at 473.

Byrne is far from settled, however. Many interpretations have been offered in subsequent cases;[248] yet all of these call for further refinement. Only the future can tell which of these interpretations will prove best.

In *Law and Revolution*,[249] Harold Berman provides another illustration of the evolutionary development of legal rules. Discussing the medieval treatment of the question of whether one who has been forcibly dispossessed of his goods has the right to regain them by force, he writes:

> One solution was reached by interpretation of the Roman law texts of Justinian, where it appears that the Roman praetor had decreed that one who has been forcibly dispossessed of his land (nothing is said about goods) may not take it back by force after a certain period of time has elapsed. The twelfth-century jurists concluded that this rule is equally applicable to goods, since the same purposes are involved in both classes of cases. Further, it had been laid down by certain church councils and in individual ecclesiastical cases that a bishop forcibly ousted from his bishopric must not resort to force to recover it. A bishopric, it was noted by the twelfth-century jurists, includes not only rights in land but also rights in goods and, in addition, rights in perquisites—rights in rights ("choses-in-action"). Such instances gave rise not only to analogies but also to hypotheses. It appeared that underlying the various rules was a basic legal principle—nowhere stated in the law but stated at this time by the legal scientists to explain the law—that persons whose rights are violated are required to vindicate them by legal action rather than by "taking the law into their own hands." This hypothesis was verified logically by the proposition that it is a basic purpose of law to provide an alternative to force as a means of settlement of disputes. It was further verified by experience, including experience of the circumstances that had given rise to the rule, namely, the disorder and injustice that resulted when disputes over rights in land, goods, and choses-in-action were settled by series of violent acts of dispossession, first by one of the disputants and

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[248] *See* Mutual Life & Citizens' Assurance Co. v. Evatt, 1971 A.C. 793, 799-813 (P.C. 1970); Nunes Diamonds Co., Ltd. v. Dominion Electric Protection Co., [1972] 26 D.L.R. 3d 699, 716-23 (S.C.C.); Scott Group Ltd. v. McFarlane, [1978] 1 N.Z.L.R. 553 (C.A.)

[249] H. BERMAN, LAW AND REVOLUTION (1983).

> then by the other. Such experience reached the level of experimentation when the jurist was able to compare the consequences of diverse legal rules and of changes in legal rules. Rules that were considered unsatisfactory sometimes were amended or repealed or fell into disuse. Rules that were considered satisfactory were often continued. Such "experiments" lacked the exactness of laboratory tests; yet they were a kind of social experimentation, a "laboratory of history"—what modern scientists would call "natural experiments." To use modern terminology, experience, including the experience of applying rules in concrete cases, was viewed as a process of constant feedback concerning the validity both of the rules and of the general principles and concepts that were thought to underlie them.[250]

Examples of this kind reveal the convergence of legal and scientific methods. But the similarity with Popper's model of scientific discovery reaches beyond the formal aspects of the process. First, it seems that, in the same way the scientist eliminates theories that are not worth testing, the legal process allows for rules that appear promising for further testing. Indeed, not all legal rules are amenable to appeal. In *Donoghue*, it can be supposed that the House of Lords agreed to review its 1842 decision because it felt reconsideration could improve the law. Had that not been the case, the lower court's decision would have stood unchanged.

Second, Popper's suggestion that bold theories are more vulnerable to refutation proves valid in this case, for the highly abstract formulation of the *Donoghue* rule allowed the court of appeal in *Candler* to limit the application of *Donoghue* by invoking the specter of pure economic loss.[251] Had the *Donoghue* rule been formulated to expressly cover cases involving pure economic loss, its explanatory power would have been proportionally higher, and it would have become vulnerable to refutation through overruling. Indeed, greater precision would have enabled a subsequent court to know the exact substantive content

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[250] *Id.* at 153. In other passages, in contrast, Berman seems to confuse evolution in the substance of the law and evolutionary discovery of an unchanging objective Law. *Id.* at 356.

[251] Candler v. Crane, Christmas & Co., [1951] 2 K.B. 164, 200, 206-07 (C.A.).

of the rule and disagree with it.[252] Instead, the rule's emptiness ruled out the possibility of criticism altogether. As a result, the precedent was merely distinguished and held not applicable in cases of pure economic loss. This new formulation, that in cases of physical damage "[y]ou must take reasonable care to avoid acts or omissions which you can reasonably foresee would be likely to injure your neighbour,"[253] was bolder than the previous one because its precision, explanatory power, and improbability were greater. Its vulnerability increased as well, as is reflected in its subsequent evisceration in *Hedley Byrne*.

Third, the importance of judges' externalizing their internal beliefs, or "articulate consistency" in Dworkinian vocabulary, is evidenced by Lord Denning's dissent in *Crane*. Because the majority of the Court of Appeal expressed its justification for refusing the damage award, Lord Denning was able to identify the point of his disagreement; he felt there was no rational basis for distinguishing between physical damage and pure economic loss.[254] The reliance of the majority upon that distinction was seemingly incorrect. But the error was alleviated when clearly formulated, for Lord Denning could then point to the error, criticize it, disagree, and offer an alternative solution. Had the majority of the Court of Appeal refused to disclose its motivation, its decision would have been irrefutable or immune to criticism. It seems therefore that, from a perspective of improving the law, if the soundness of judicial statements remains indeed desirable, their externalization is clearly essential.

Fourth, judges are practical men in the Popperian sense.[255]

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[252] One could wonder whether it is, in fact, desirable in law as it is in science that rules be bold and thus more vulnerable to criticism. If it is true that greater boldness increases the possibility of improvement through criticism and error correction, greater boldness also entails a loss in stability of the law. This apparent conflict between flexibility and stability of the law is discussed *infra* Subsection III.C.2.

[253] *See supra* note 239.

[254] *See supra* note 244.

[255] Popper's distinction between theoretical and practical minds, *see supra* note 194, resembles Plato's distinction between apodictic and decisional knowledge. The former is axiomatic, logical, deductive; the latter is situational, value-laden, grounded on alternatives. Plato believed decisional knowledge to be more important than apodictic knowledge. In fact, he doubted that the latter could exist outside of a prior decisional framework. *See* CUSHMAN, THERAPEIA: PLATO'S CONCEPTION OF PHILOSOPHY 269-70 (1958).

Because the quest for justice is undertaken indirectly through eliminating injustice, one may raise the objection that judicial decisions are never truly just. Since legal rules are always subject to further improvement, it may be argued that the rights of the parties at bar are sacrificed in the name of global improvement. Even if the objection is sound in theory, in practice it is pointless. Indeed, judicial abstention is impossible; each case calls for a decision one way or the other. Faced with this practical requirement, judges are perfectly justified in relying upon the "best" legal rule, even though they can never be assured that this best rule is truly just. The reason is that they have no alternative: there is no way to demonstrate affirmatively the justice of a legal rule. Moreover, if the positive rights of the parties may be described as "sacrificed" through the process, this sacrifice is undertaken in the name of greater respect for higher rights.

Hayek sums up the analogy between scientific and legal evolutionary process in these words:

> The contention that the judges by their decisions of particular cases gradually approach a system of rules of conduct which is most conducive to producing an efficient order of actions becomes more plausible when it is realized that this is in fact merely the same kind of process as that by which all intellectual evolution proceeds. As in all other fields advance is here achieved by our moving within an existing system of thought and endeavouring by a process of piecemeal tinkering, or "imminent criticism," to make the whole more consistent both internally as well as with the facts to which the rules are applied. Such "imminent criticism" is the main instrument of the evolution of thought, and an understanding of this process the characteristic aim of an evolutionary (or critical) as distinguished from the constructivist (or naive) rationalism.[256]

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[256] F. HAYEK, *supra* note 157, at 118-19. Unfortunately, Hayek then goes on to apply this evolutionary process to the substantial creation of the law. He writes:

> Since new situations in which the established rules are not adequate will constantly arise, the task of preventing conflict and enhancing the compatibility of actions by appropriately delimiting the range of permitted actions is of necessity a never-ending one, requiring not only the application of already established rules but also the formulation of new rules necessary for the preservation of the order of actions.

Id.

3. Objectivity in Law: The Issue of Judicial Discretion

Popper's description of the interplay between the second and third worlds provides the epistemological background for Dworkin's distinction between strong and weak judicial discretion. If there is such a thing as an autonomous third world, then the Dworkinian notion of imperfect judicial restraint makes sense. Judges are not left without standards in deciding cases. Instead, there would be a legal third world that provides them with objective constraints they must respect. The judicial grasp of these objective constraints would not be perfectly objective, however. In the same way that the second world influences the perception of the third world, judges' perceptions of the legal objective constraints would be slightly biased by their innate dispositions. Briefly stated, if Popper's description of the interplay between the second and third worlds is applicable to judicial reasoning, then Dworkin's claim that only weak discretion is involved in judicial decision-making is sound.

Popper's description of the interplay between the second and third worlds seems to be applicable to judicial reasoning. Conversely, the division between institutional materials and personal values in law was recognized by Aquinas[257] and seems widely acknowledged among legal scholars.[258] Hayek explains: "The judge may err, he may not succeed in discovering what is required by the rationale of the existing order, or he may be misled by his preference for a particular outcome of the case in

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[257] T. AQUINAS, SUMMA THEOLOGICA, Q. 91, art. 1, in INTRODUCTION TO SAINT THOMAS AQUINAS 610-11 (A. Pégis ed. 1948). Aquinas wrote:

> Just as, in external action, we may consider the work and the work done, for instance, the work of building and the house built, so in the acts of reason, we may consider the act itself of reason, *i.e.*, to understand and to reason, and something produced by this act.

Id. Perhaps Aquinas had not had the chance to be enlightened by the idealists who followed him!

[258] *See* Weiler, *Legal Values and Judicial Decision Making*, 48 CAN. B. REV. 1, 19 (1970) (arguing that judge is able to follow probable implications of principle even if such implications conflict with his personal beliefs and preferences); *see also* J. ELY, *supra* note 23, at 7 (noting that no serious challenge exists to notion of majoritarian control); Wirth, *Preface* to MANNHEIM, IDEOLOGY AND UTOPIA at xxii-xxviii (1936) (distinguishing taking account of ends and settling ends). *But see* Greenawalt, *supra* note 122, at 359 *passim* (advocating judicial discretion).

hand . . . . This is a task in which his "will" or his emotional response has no place."[259] According to these opinions, judicial restraint is at least conceivable. However, in the event that judges prefer to base their decisions on their personal preferences in spite of a capacity for judicial restraint, a further control mechanism exists, the judicial obligation that judgments be motivated.[260] Since it is theoretically possible for judges to tend toward impartiality and the judicial obligation of disclosure provides a certain form of control mechanism, Dworkin's model of two forms of discretion is compelling.

On the other hand, applying the Popperian model of reciprocal interaction between the second and third worlds to judicial reasoning would suggest that judges' personal values are in turn influenced by institutional developments in the law. If, as suggested earlier, institutional materials and personal values are conceptually distinct, then this feedback phenomenon probably occurs; otherwise personal opinions would not be amenable to change. Yet it is an observable fact that opinions do evolve through rational discussion.

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If the Dworkinian and Popperian models are correct, their general similarity implies that there is no distinction in kind between the modes of reasoning in physical, or so-called exact, sciences and in humanities such as law; rather, the distinction is one of degree.[261] Indeed, the exactitude of physical sciences is no longer immune to challenge.[262] Moreover, Popper himself ac-

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[259] F. HAYEK, *supra* note 157, at 119-20.

[260] *Id.* "[A]lthough he may not know what led him in the first instance to think that a particular decision was right, he must stand by his decision only if he can rationally defend it against all objections that can be raised against it." *Id.* at 120.

[261] Polanyi argues forcefully against severing physical sciences from humanities. *See* M. POLANYI, PERSONAL KNOWLEDGE: TOWARDS A POST-CRITICAL PHILOSOPHY (1962); M. POLANYI, THE STUDY OF MAN (1959); *see also* Brandt, *Parallel Between Epistemology and Ethics* in 3 THE ENCYCLOPAEDIA OF PHILOSOPHY 6-8 (P. Edwards ed. 1967).

[262] Northrup, writing on Heisenberg's principle of indeterminacy, reasoned, "Physics is neither epistemologically nor ontologically neutral." Northrup, *Introduction* to HEISENBERG, PHYSICS AND PHILOSOPHY: THE REVOLUTION IN MODERN SCIENCE 25 (1958); *see also* P. BRIDGMAN, THE WAY THINGS ARE 8-9, 128-99 (1959) (conceptual revolution with abandonment of certainty through instrumentally extended knowledge of universe); P. BRIDGMAN, THE LOGIC OF MODERN PHYSICS, at vii-xi, 1-65 (1927) (operational point of

knowledges that even if it is true that testing proves more difficult and less rigorous in the humanities than in the exact sciences, this difficulty does not necessarily suggest that his picture of scientific reasoning is altogether inapplicable to social sciences. On the contrary, Popper asserts that several parallels may be drawn between physical and social sciences.[263]

Dworkin's model diverges from the Popperian method in one aspect. Before conclusions are drawn as to the relation between scientific and legal reasoning, this divergence must be further examined.

B. The Difference Between Dworkin's and Popper's Models

If we reason by analogy to Popper's thoughts about science, various criteria are available for judges to evaluate the validity of competing theories. Correspondence to reality and coherence with previous theories are two such irreconcilable criteria. In proposing a twofold test of fit and value for identifying the best legal rule,[264] Dworkin, unlike Popper, embraces a criterion of validity that is consistent with Popper's description of a coherence theory of truth. In his view, a judge's ultimate task is to "identify legal rights and duties, so far as possible, on the assumption that they were all created by a single author—the community personified—expressing a coherent conception of justice and fairness."[265] As indicated above, this coherence conception of

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view on relativity of empirical knowledge); J. JEANS, PHYSICS AND PHILOSOPHY, 126-52, 174-79, 191-217 (1943) (uncertainty and indeterminism as products of expanding knowledge); T. KUHN, THE STRUCTURE OF SCIENTIFIC REVOLUTIONS 1-173 *passim* (2d ed. 1970) (scientific revolution through abandonment of prior paradigms and adoption of new ones); Miller & Howell, *supra* note 232, at 666-68 (lack of neutrality in physical sciences). It should be noted that none of these scholars' views are consistent with Popper's. They are here mentioned merely to buttress the suggestion that certainty in physical sciences can no longer be taken for granted.

[263] K. POPPER, CONJECTURES AND REFUTATIONS, *supra* note 162, at 253; K. POPPER, OBJECTIVE KNOWLEDGE, *supra* note 8, at 186 n.36, 190 n.41. He is supported in this statement by Aquinas' belief that "human laws cannot have that inerrancy that belongs to the demonstrated conclusions of the sciences. Nor is it necessary for every measure to be altogether unerring and certain." T. AQUINAS, *supra* note 257, art. 4, at 621.

[264] *See supra* Subsection I.A.2.

[265] R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 225. It should be noted at this point that this conception of the judicial function predates Dworkin. In 1923, Roscoe Pound published his *Theory of Judicial Decision*, Pound, *supra* note 71, at 645-46, in which he

justice and fairness is Dworkin's "political morality."

This test of coherence with political morality presents several problems. The first concerns the concept of political morality itself. What is political morality? Dworkin defines it in terms of institutional materials that are grounded in particular "legislative convictions." But what are legislative convictions? Are these convictions any more tangible and substantive than the notion of legislative intent rejected by Dworkin because of its emptiness? True to the interpretive nature of his jurisprudential enterprise, Dworkin refuses to provide definitions.[266] Hints as to the substance of political morality are scattered throughout his work, but the question is never confronted straightforwardly. However, if the interpretive process does forbid the proposition that any definition is immutably settled, surely it does not militate against the formulation of tentative definitions. On the contrary, articulate consistency demands that theories be posited explicitly to allow for criticism and improvement.

Even if the components of political morality were clearly set out, there remains a problem of geographical boundaries. Let us assume, for the sake of simplicity, that political morality is reduced to a particular set of legislative and judicial provisions, X and Y. Should judges consider only the X's and Y's of their own jurisdiction? Should judges take into account the X's and Y's of all common law jurisdictions that are culturally similar to the United States, or should they limit their inquiry to the X's and Y's of their own country or their state? What if the parties to the action belong to a particular religious community that abides by rules entirely different from the rules of the majority? Rationally, the shrinking of the boundaries can be pursued down to the individual level, and if there is one political morality for each individual, then there is no morality at all.[267]

Let us even assume for the moment that Dworkin could identify rational jurisdictional boundaries for political morality. Is it clear that there is a coherent body of principles to be recon-

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set forth a similar view.

[266] *See supra* note 44.

[267] *See* S. FISH, *supra* note 1, at 109 (existence of multiple standard implies existence of no standard at all). Reduction from the community to the individual level is demonstrated in R. NOZICK, ANARCHY, STATE AND UTOPIA (1974).

structed? Perhaps documents X and Y are inherently and insuperably contradictory. Dworkin could reply, as he does to a different objection, that inherent contradiction in institutional materials is one possible interpretation of the law and that it falls to its proponents to demonstrate its superiority over competing interpretations. Such a demonstration is not entirely out of the question. Those who take the view that X's and Y's are inherently contradictory can offer two arguments to support their claim. First, Critical legal scholars' extensive deconstructionist literature is not far from successfully demonstrating that a search for consistency in law that is restricted to institutional materials is doomed to failure.[268] Second, given that legislation is often the result of a struggle between various interest groups and is thus devoid of rational basis in most cases, their inclusion by Dworkin into the reconstruction process is dubious. If coherence can be expected from the judiciary, such expectation is, as acknowledged by Dworkin himself, clearly mistaken when directed at the legislature.[269] Moreover, the purpose of statutes is often explicitly that of modifying or repealing a certain body of precedent. In these circumstances, search for coherence between judicial and legislative enactments is surely hopeless.

The second problem with Dworkin's test of coherence with political morality is more serious. It concerns the relationship between the two dimensions of fit and value. What should judges do when a binding precedent that does not qualify as a "mistake"[270] or a legislative enactment that is procedurally flawless conflicts with political morality?[271] According to the dimension of fit, the precedent or legislative enactment is part of binding institutional materials and hence calls for enforcement.

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[268] It is, indeed, the claim of the CLS movement that legal materials and doctrines are inherently contradictory and that, as a result, any attempt at reconstruction into a body of coherent principles is vain in the absence of standards external to these materials. *See generally Critical Legal Studies Symposium*, 36 STAN. L. REV. (1984). This particular claim of CLS deconstructionism helped extricate legal thought from the dark age of formalism and must therefore be lauded. However, as discussed *infra*, one need not embrace its subsequent tenet that no external standard can be found anywhere.

[269] R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 113-14.

[270] For Dworkin's theory of mistake, see *supra* Subsection I.A.3.b.

[271] Dworkin acknowledges that such conflicts are possible. R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 101.

According to the dimension of value, however, the diverging precedent or legislative enactment ought to be disregarded in order to improve the global coherence of the law. As a result, when fit and value point to conflicting outcomes, a judge faces the difficult task of selecting one or the other.

Dworkin puts strong emphasis on the dimension of fit. Indeed, even when describing his conception of political morality —that is, when discussing the value component of his twofold test—he insists on the importance of fit in law as integrity. As a result, it is conceivable that he would tell the judge to select the dimension of fit in situations of conflict between fit and value. In that case, however, the only standard for improvement of the law is internal; legal rules are interpreted against the background formed by previous legal rules. The problem with such internalistic interpretation is that it does not allow for the correction of error. If the first legal rule is wrong from a moral standpoint and the only test for the validity of subsequent rules is coherence with the first one, then the error of the first rule will be perpetuated in all subsequent ones.[272]

In both *Candler*[273] and *Hedley Byrne*,[274] the judges appealed to standards external to institutional materials to render their decisions. In *Hedley Byrne*, Lord Devlin relied upon logic and common sense to reject the distinction drawn in *Crane* between physical damage and pure economic loss.[275] In *Candler*, Lord Asquith referred directly to a sense of justice and indirectly to Lord Atkin's intention in *Donoghue*.[276] One might argue that judicial intention is an internal standard that would have sufficed to dispose of the case and that this proves that external standards are not essential to adjudication. This argument is, however, mistaken, for when Lord Asquith wrote that

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[272] In a regime such as Nazi Germany, for example, a judge bound only by the standard of coherence would have to enforce violations of rights because similar ones were enforced in the past.

[273] *See supra* note 240 and accompanying text.

[274] *See supra* note 246 and accompanying text.

[275] *Hedley Byrne & Co. v. Heller*, 1964 A.C. 465, 486 (1963). "The interposition of the physical injury is said to make a difference of principle. I can find neither logic nor common sense in this." *Id.* Lord Reid concludes, "If that is right, then it must follow that *Candler v. Crane, Christmas & Co.* was wrongly decided." *Id.* at 487 (Reid, L.J.).

[276] *See supra* note 237 and accompanying text.

he "[could not] believe that so broad an application was intended by Lord Atkin,"[277] he really meant, it is suggested, that, if truly intended by Lord Atkin, such a broad application contradicted his own sense of justice. As explained by Dworkin (and here, Dworkin is right), appeal to the speaker's intent does not eliminate interpretation; the speaker's intent must be interpreted by reference to something external to it.

Where Dworkin is mistaken is in his selection of a standard. The standard he offers, political morality, is indeed external to intent, but it is not external to institutional materials or positive law. Without an external criterion by which institutional materials can be changed, the evolutionary legal process canvassed by Dworkin loses potency, for aimless change is stagnation.[278] That no external standard exists to guide change is precisely the claim of relativism and hence, it is suggested, of internalism. As a result, should Dworkin tell judges to give preference to fit over value, he would then qualify as internalistic and would thus be clothing his thesis in metaphysical relativism.

Despite his claim that metaethical discourse is impossible, Dworkin denies allegiance to relativism.[279] Indeed, it seems that he recognizes the need for some external standard, for he would advise judges to favor value over fit in cases of conflict.[280] If this

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[277] Candler v. Crane, Christmas & Co.,[1951] 2 K.B. 164, 189 (C.A.) (Asquith, L.J.).

[278] Similarly, if Popper had excluded the first world from his model of scientific knowledge, the interplay between the second and third worlds would not have sufficed to produce improvement. The third world would result from the second one, and the second world would be modeled by the third world in perfect circularity. The circularity is broken only when an external factor comes into play. The interplay between second and third worlds must aim at matching the basic statements about the first world. Because of this external factor, what could have remained mere internal circularity will become global progression.

[279] Dworkin, *A Reply by Ronald Dworkin*, in RONALD DWORKIN AND CONTEMPORARY JURISPRUDENCE, *supra* note 62, at 278-81.

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> [T]he judge seeking to do what is morally right is faced with a familiar sort of conflict: the institutional right provides a genuine reason, the importance of which will vary with the general justice or wickedness of the system as a whole, for a decision one way, but certain considerations of morality present an important reason against it. If the judge decides that the reasons supplied by background moral rights are so strong that he has a moral duty to do what he can to support these rights, then it may be that he must lie, because he cannot be of any help unless he is understood as saying, in his official role, that the

is the case and if, as suggested above,[281] external standards cannot be found in political morality, then Dworkin's model is not different from a non-conventionalist model of adjudication such as natural law.[282] One could reply that situations of conflict between fit and value are rare, and that the Dworkinian model thus remains viable outside a non-conventionalist context in other situations. This reply is unsatisfactory, however, for it is precisely in situations of conflict that the difference between conventionalism and non-conventionalism becomes important.[283]

C. *Dworkin's Model Corrected: The Example of Externalistic Adjudication*

This section presents a slight variation on Dworkin's model; the flaws identified in the previous section are corrected. The result is an externalistic model of adjudication. The external standard provided is taken from natural law jurisprudence, but other jurisprudential trends could fulfill the task equally well. No discussion of the form and substance of this natural law standard is undertaken here; the aim is strictly methodological.

1. The Judicial Process Revisited

In the same way that objective knowledge evolves outside subjective minds from the aggregate of individual rational interventions, positive law is "a going order which nobody has

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legal rights are different from what he believes they are.

R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 326-27; *see also id.* at 122 (determination that precedent has little current force or is unjust erodes fairness argument that supports that precedent). Moreover, conventionalism is rejected as unsatisfactory on the basis that it does not allow for substantive change in the law. *See* R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 137-39.

[281] *See supra* Section III.B.

[282] Natural law is not the only external standard available. Certain forms of contractarianism and utilitarianism would do. However, given Dworkin's appeal to morality, political or not, and his parallel rejection of efficiency, natural law appears best suited to provide the external standard in this case. Indeed, the concrete examples of Herculean adjudication given by Dworkin are often strikingly similar to natural law adjudication. For additional examples that seemingly conform to natural law adjudications, see R. DWORKIN, LAW'S EMPIRE, *supra* note 6, at 105-06.

[283] Soper, *Legal Theory and the Obligation of a Judge: The Hart/Dworkin Dispute*, in RONALD DWORKIN AND CONTEMPORARY JURISPRUDENCE, *supra* note 62, at 21.

designed, an order that has formed itself without the knowledge and often against the will of authority, that extends beyond the range of deliberate organization on the part of anybody, and that is not based on the individuals' doing anybody's will, but on their expectations becoming mutually adjusted."[284]

Progression toward natural law, like progression toward scientific truth, is achieved through reason.[285] Reason allows us to use the descriptive and argumentative functions of our language to criticize positive legal rules. Criticism is achieved by comparing the potential judicial outcomes, or, in Popperian terms, judicial occurrences, of the legal rule in question with our sense of justice or perception of natural law. This criticism allows us to eliminate rules that diverge from our perception of natural law. Although perfect harmony with natural law will never be achieved, gradual improvement is possible.

But how can a judge know that a particular solution diverges from or conforms with natural law? Aquinas explains that all human beings have access to the notions of rightness and wrongness through their consciences.[286] Although such access is sometimes difficult and is not immune from error,[287] these no-

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[284] F. HAYEK, *supra* note 157, at 119-20.

[285] Propounding this principle, Aquinas wrote:

> Accordingly, we conclude that, just as in the speculative reason, from naturally known indemonstrable principles we draw the conclusions of the various sciences, the knowledge of which is not imparted to us by nature, but acquired by the efforts of reason, so too it is that from the precepts of the natural law, as from common and indemonstrable principles, the human reason needs to proceed to the more particular determination of certain matters. These particular determinations, devised by human reason, are called human laws, provided that the other essential conditions or law be observed . . . .

T. AQUINAS, *supra* note 257, art. 3, at 620.

[286] "Consequently, it follows that law is something pertaining to reason . . . . But in order that the volition of what is commanded may have the nature of law, it needs to be in accord with some rule of reason." *Id.*, Q. 90, art. 1, at 610-11. In his gloss on Romans 2:14, Aquinas wrote: "Although they have no written law, yet they have the natural law, whereby each one knows, and is conscious of, what is good and what is evil." *Id.*, Q. 91, art. 2, at 618. Dworkin himself refers to our sense of justice to determine the rightness or wrongness of a decision. R. DWORKIN, A MATTER OF PRINCIPLE, *supra* note 5, at 161.

[287] In contrast, Kant believes that categorical imperatives lie within human conscience. As a result, conscience requirements cannot be defective; the right and the wrong are what is perceived by the conscience; *see* I. KANT, *Preface to the Metaphysical*

tions are discoverable through rational discussion. Since not all men are equally capable of rational discussion, discovery will prove easier for some of us.[288] Few will deny that we all intuitively feel that things are right or wrong. The fundamental question then becomes: Do we all share the *same* intuitions as to rightness and wrongness?

The answer to this question proceeds from Popper's concept of basic statements. In the same way that, for procedural purposes, the jury's verdict is considered a satisfactory interpretation of the facts,[289] our search for what is right and wrong will be deliberately stopped, for adjudicative purposes, at a point considered satisfactory by the adjudicators.[290] Indeed, judges often hold the view that certain actions or behavior is "unjust," "unfair," or "morally reprehensible." In holding these views, they are expressing basic statements about morality. For example, the view that slavery is morally reprehensible can safely be said to constitute a basic statement of natural law; this is not to say, however, that this statement is immune to challenge.

It seems, therefore, that when Dworkin's coherence standard is replaced by one of correspondence with our perception of

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Elements of Ethics, in KANT'S CRITIQUE OF PRACTICAL REASON AND OTHER WORKS ON THE THEORY OF ETHICS 321-22 (6th ed. 1909) (inerrancy of conscience).

[288] Elaborating on this truism, Aquinas wrote:

> Consequently, we must say that the natural law, as to the first common principles, is the same for all, both as to rectitude and as to knowledge. But as to certain more particular aspects, which are conclusions, as it were, of those common principles, it is the same for all in the majority of cases, both as to rectitude and as to knowledge; and yet in some few cases, it may fail, both as to rectitude, by reason of certain obstacles (just as natures subject to generation and corruption fail in some few cases because of some obstacle), and as to knowledge, since in some the reason is perverted by passion, or evil habit, or an evil disposition of nature.

T. AQUINAS, *supra* note 257, Q. 91, art. 3, at 620.

[289] For Popper's discussion of the jury's function in judicial procedure, see *supra* note 180.

[290] Some might feel that, by using basic statements that result from an inter-subjective agreement upon morality, we are falling back into the conventionalism we wished to avoid. This feeling is mistaken, however, since the inter-subjective agreement does not supply the standard to be applied, but is rather directed to the question of whether the standard is met or not. Popper explains: "[T]he convention or decision does not immediately determine our acceptance of universal statements but . . . on the contrary, it enters into our acceptance of the singular statements—that is, the basic statements." K. POPPER, THE LOGIC OF SCIENTIFIC DISCOVERY, *supra* note 158, at 109.

natural law, his evolutionary model of judicial reasoning becomes consistent with natural law adjudication. Dworkin's account of the role of precedents and legislation should thus be slightly modified in the following way.

New cases constantly arise to challenge existing positive rules. The judge must first determine whether some common law rules apply so that the case at bar is affected by the "gravitational force" of previous judicial decisions. The judge will use an existing rule only if the solution it dictates conforms with our basic statements about natural law. If not, then the rule must be modified or discarded. The judge cannot maintain the rule by creating an exception for the case at bar.[291] Exceptions are not possible, for justice requires that all cases be solved in a consistent manner. If a new case arises that conflicts with an existing rule, two alternative conclusions are possible. First, either the case or the rule is wrong from the standpoint of justice. The new case and the old rule cannot both be right and yet conflict if the same standard is used in their evaluation. The second possible conclusion is that the case at bar is not covered by the conflicting positive rule, in which case, the judge must repeat the analysis with another rule he thinks applicable, or formulate a new one.

In the absence of existing rules applicable to the case at bar, the judge will formulate a new rule. For this new rule to be a valid interpretation of the law, however, a Popperian judge would stress that it must be universal, that is, not ad hoc. The new rule must be formulated prospectively,[292] with the view that

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[291] Popper condemns the conventionalist allowance for exception:

> Whenever the "classical" system of the day is threatened by the results of new experiments which might be interpreted as falsifications according to my point of view, the system will appear unshaken to the conventionalist. He will explain away the inconsistencies which may have arisen, perhaps by blaming our inadequate mastery of the system. Or he will eliminate them by suggesting ad hoc the adoption of certain auxiliary hypotheses, or perhaps of certain corrections to our measuring instruments.

Id. at 80.

Dworkin proceeds consistently with Popper's view, by search for and refutation of counterexamples, in a way that does not allow for exceptions. *See* R. DWORKIN, TAKING RIGHTS SERIOUSLY, *supra* note 4, at 301-11, 318, 324.

[292] Prospective formulation should not be confused with prospective overruling. Whereas the latter excludes the case at bar from the future overruling of a precedent,

it will be tested against subsequent cases. Moreover, the new rule cannot conflict either with other existing rules or with more abstract moral principles. Once again, conflict with another rule would mean that one of them is wrong. Conflict with moral principles is not allowed simply because morality is the ultimate standard to which valid rules must conform.

Since our basic statements about justice are not infallible, conforming with natural law is sometimes difficult to evaluate. As a result, legal rules can never be taken as immutably settled. It is only through further testing in subsequent cases that the rightness of a rule will be supported or denied. The judge must try to render the best decision in each case, for the parties to an action are entitled to be treated as justly as humanly possible. But judges are fallible, and mistakes, inevitable. Mistakes are not fatal, however, since the legal process is one of constant correction. Through rational criticism, error will be eliminated. In the same way that scientific knowledge is the result of a complex decoding process in which correction plays a major role, judicial knowledge grows from the qualitative evolution of precedents, rather than from their quantitative accumulation.[293]

Legislation and law are not the same. Although the distinction may not be obvious in English, other languages distinguish law as legislation and precedents from Law as justice. In French, law is *loi*, and Law is *droit*; in Latin, law is *lex*, and Law is *jus*. This distinction is meaningless for positivists, since in their view Law is coextensive with law. From a natural law perspective, however, law is subordinate to Law.[294] In this way, constitutional

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the former includes the case at bar for purposes of the enforcement of a rule formulated with regard to future fact situations. For an example of prospective overruling, see Jones v. Secretary of State for Social Servs., 1972 A.C. 944, 1025-26 (1971). For further discussion, see Freeman, *Standards of Adjudication, Judicial Law-Making and Prospective Overruling*, 26 CURRENT LEG. PROB. 166 (1973).

[293] Holmes was almost right when he wrote that "[t]he life of the law has not been logic; it has been experience." O.W. HOLMES, THE COMMON LAW 1 (1948). The life of the law is neither sheer logic, nor mere experience: it is experience as decoded through logic.

[294] Aristotle wrote: "Of political justice part is natural, part legal, —natural, that which everywhere has the same force and does not exist by people's thinking this or that; legal, that which is originally indifferent, but when it has been laid down is not indifferent . . . . " ARISTOTLE, *Nicomachean Ethics*, bk. V, ch. 6, in 2 THE COMPLETE WORKS OF ARISTOTLE 1790-91 (J. Barnes ed. 1984).

and legislative provisions derive binding force from their status as a human translation of the higher form of Law, natural law.[295] The function of legislation is reduced to facilitating access to natural law.[296]

The Constitution is more likely than statutes to reflect morality accurately. This is because constitutional clauses are broad, and consequently, in Popperian terms, more likely to survive attempts at refutation. The flip side of this coin is that their explanatory power is nonproportionately reduced. It is because of the low explanatory power of constitutional clauses that statutes are called into play to provide greater information. In contrast, statutes are more vulnerable to testing or, in legal terms, more likely to become obsolete and be repealed. Dworkin pictures the mutual complementarity between constitutional and statutory dispositions as an interplay between concepts and conceptions.[297] Concepts are more stable but less informative and must therefore be supplemented with more vulnerable but less abstract conceptions.[298] This description of a constitution as a bulk of concepts explains its resistance to social change, or intertemporality.[299] To describe statutes as conceptions properly

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[295] This conception of rules as merely informative was pervasive in the English tradition. *See* Siegel, *The Aristotelian Basis of English Law 1450-1800*, 56 N.Y.U. L. REV. 18, 23-40 (1981).

Nickel rightly outlines the circularity of the conventionalist conception of the Constitution. He explains that the Constitution cannot be taken as the manifestation of the People's will because such a view renders judicial review pointless. Indeed, "[t]o leave the recognition of rights claims to the very official against whom the rights obtain is to allow those officials to be judges in their own cases." Nickel, *Dworkin on the Nature and Consequences of Rights*, 11 GA. L. REV. 1115, 1132 (1977).

[296] The only reason Aristotle and Aquinas would restrict judicial action in favor of legislative action is that they considered the latter less susceptible of corrupting natural law. *See* ARISTOTLE, *Rhetoric*, bk. I, ch. 1, in 2 THE COMPLETE WORKS OF ARISTOTLE 2152-53 (J. Barnes ed. (1984); T. AQUINAS, *supra* note 257, Q. 95, arts. 1-2, at 646-50. The same motivation underlies Bickel's positivism. *See* A. BICKEL, THE LEAST DANGEROUS BRANCH: THE SUPREME COURT AT THE BAR OF POLITICS (1962).

[297] This picture of the Constitution is widely endorsed. For further discussion, see Grey, *Origins of the Unwritten Constitution: Fundamental Law in American Revolutionary Thought*, 30 STAN. L. REV. 846 (1981); Munzer & Nickel, *supra* note 115.

[298] Dworkin's claim that the distinction between concepts and conceptions is one of kind is debatable. It seems that a distinction of degree would prove more accurate, since the only difference lies in the level of abstraction. *See* Munzer & Nickel, *supra* note 115, at 1051. Nevertheless, the distinction remains useful even as one of degree.

[299] This attribute of a constitution was perceived by Marshall in McCulloch v. Ma-

accounts for their temporary character.

Judges must look at legislation to guide their decisions. Their interpretation of a statutory provision must be the best one possible from the perspective of morality. Since the Constitution appears to be the most reliable reflection of natural law, judges will interpret statutes in accordance with the Constitution. But understanding the Constitution is also an interpretive process. Each constitutional provision must be read in turn as the best interpretation of our basic statements of natural law. Once again, because of the generality of constitutional terms, their interpretation is less likely to fluctuate. Nevertheless, like statutory interpretation, constitutional interpretation is an evolutionary process that precludes certainty.

Cases may arise in which statutory words do not allow for an interpretation consistent with the Constitution. In these cases, positivist "clear" cases, judges will undertake to strike down the statute by judicial review.[300] Should constitutional provisions themselves derogate from natural law, judges must disregard them in the hope of provoking a constitutional amendment.

2. Three Objections to the Externalistic Model

Three possible objections to the externalistic model of judicial reasoning are addressed below. The following discussion is not, however, aimed at exhausting the issues raised. Rather, it is intended as a brief account of how one is to proceed in replying to these objections.

a. The Existence of External Standards

Basic statements about morality are often made by judges

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ryland, 17 U.S. (4 Wheat.) 316, 407 (1819). "[A constitution] is intended to endure for ages to come, and consequently, to be adapted to the various crises of human affairs." *Id.*

This conception of constitutional interpretation corresponds to Frank Michelman's "weak perfectionism," illustrated in Michelman, *supra* note 113, at 406-12, 415.

[300] The principle which justifies such judicial action was noted by Aquinas: "Hence the force of a law depends on the extent of its justice. . . . But if in any point it departs from the law of nature, it is no longer a law but a perversion of law." T. AQUINAS, *supra* note 257, Q. 95, art. 2, at 649.

and laymen alike. This common use of moral basic statements could be interpreted, it is submitted, as a direct reference to an external form of justice, or natural law, and thus it makes the conjecture of the existence of such justice intuitively appealing. But the existence and accessibility of natural law, as of any other external standard, remain ultimately indemonstrable. In the same way that realism is, according to Popper, ultimately both indemonstrable and irrefutable, the existence of natural law can neither be proved nor refuted.[301] Like realism, the naturalistic thesis may be preferred over alternative metaphysical theories.[302] Indeed, some arguments exist in favor of natural law that might lend intuitive appeal to this.[303] Popper's argument in favor of realism is here appropriate. When asked to explain our intuition, we try to provide rational arguments. The possibility of rational discussion about rightness and wrongness, the possibility of logical argumentation and modification of one's opinion are strong indicators that rightness and wrongness may exist outside subjective minds. But does the uncertainty surrounding the existence of natural law undermine the viability of adjudication by appeal to external standards? The availability of potential standards other than natural law suggests that it does not. Even if there were no alternative standards, however, the model would remain viable, for one need not appeal directly to natural

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[301] Indeed, even Kant admits that the proof of the existence of categorical imperatives belongs to the realm of faith and is not, as a result, open to rational argumentation. I. KANT, *supra* note 227, at 22-25.

[302] It is not here suggested that, from an ethical point of view, Popper would be pleased with applying his metaphysical discussion of realism to the present ethical concerns. But whether Popper approves or disapproves of this application does not undermine the soundness of drawing parallels between his scientific method and legal reasoning.

[303] Aquinas deduced from the purposive nature of human action that human existence itself could not be devoid of ultimate purpose. For a discussion of his five proofs of the existence of God, see T. AQUINAS, *supra* note 257, Q. 2, art. 3, at 25-27.

This teleological argument corroborates Aristotle's faith in higher Law. Discussing Sophocles' Antigone, Aristotle wrote, "If the written law tells against our case, clearly we must appeal to the universal law and to equity as being more just." ARISTOTLE, *supra* note 296, ch. 15, at 2190; *see also* Siegel, *supra* note 295, at 33 (discussing Aristotle's notion of "first principles" as certain and immutable truths).

Although neither the Thomist argument nor the Aristotelian belief is conclusive, they jointly supply the groundstone for the powerful judeochristian tradition. Grey, *supra* note 24, at 860.

law; basic statements about morality suffice for adjudicative purposes.

In any event, the absence of external standards in no way reinforces the case for internalism. Indeed, even if the existence of internal standards could be demonstrated, these standards would fail to supply a valid alternative to their external counterparts. The reason is simple: because of their internal character, such standards are entirely useless for purposes of guiding evolution, legal or otherwise. The only alternative to an absence of external standards is, therefore, no standard at all. Internalism is not a middle ground between externalism and a total absence of adjudicative standards.[304] Those who endorse the latter view must be ready to accept the conclusions that logically follow from their denying that standards exist, that is, nihilistic conclusions. Indeed, if no standard is available to guide improvement, any change in whatever direction is normatively equal to any other. In other words, in the absence of external standards, nihilistic adjudication prevails and anything goes.

b. The Limits of Reason

Against the externalistic model of judicial reasoning, one could raise the objection that not all matters are amenable to logical deductive reasoning. While some cases may be solved by deduction from abstract (moral) principles and may thus be classified as "rationally determinable," others can only be decided by appeal to common sense and are hence better described as "judgmentally determinable."[305] For example, whether we should drive on the right or the left side of the road and whether the "best" speed limit is fifty-five miles per hour or sixty miles per hour is not a priori determined by absolute principles. Like most purely conventional matters, these questions are to be decided by appeal to judgment or common sense alone.

The fervent externalist could reply, however, that judges

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[304] *See* Leff, *Book Review*, 29 STAN. L. REV. 879 (1977)(demonstrating this effect). *But see* Mackie, *The Third Theory of Law*, 7 PHIL & PUB. AFF. 1 (1977).

[305] Kant draws, and insists upon, this distinction. *See* I. KANT, *Fundamental Principles of the Metaphysics of Morals*, in KANT'S CRITIQUE OF PRACTICAL REASON AND OTHER WORKS ON THE THEORY OF ETHICS, *supra* note 287, at 9-84.

should not be confronted with the task of adjudicating judgmental matters simply because these matters are not for them to determine. Judgmental matters, the externalist would maintain, should be left for individuals to decide; the law should concern itself solely with those matters for which a "right answer" is dictated by higher objective principles. As lucidly expressed by the nineteenth century legal theorist Elisha Hurlbut, "[T]he laws shall be merely declaratory of natural rights and natural wrongs, and . . . whatever is indifferent to the laws of nature shall be left unnoticed by human legislation . . . . Legal tyranny arises whenever there is a departure from this simple principle."[306] With respect to traffic regulation examples, one might be led to conclude that the impossibility of rational adjudication indicates that legislative intervention in this field is illegitimate. Should the traffic system be privately run, its regulation would, indeed, be transferred from the legislative/judicial to the individual sphere of action.

But judges cannot be entirely exempted from judgmental adjudication. Sentencing is one example of matters that properly fall within the judicial sphere.[307] Externalism offers a two-part answer to this objection. First, if it is true that some judgmental matters remain for judicial determination, the preceding argument concerning the proper sphere of legal intervention indicates that their number is far more limited than initially thought. Second, if judges must adjudicate the few judgmental questions that remain within their jurisdiction, such adjudication is not entirely discretionary. Our sense of justice provides limits to this judicial discretion. For example, if few would invoke a higher justice to object to a twenty-four-year, as opposed to a twenty-five-year, jail sentence for first degree murder, it can safely be asserted that many would find five years offensive. With respect to judgmental matters, external standards fail to dictate a "right answer." What these standards do provide, nonetheless, are means to control abuse.

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[306] *See* B. WRIGHT, AMERICAN INTERPRETATIONS OF NATURAL LAW 257 (1931)(quoting E. HURLBURT, ESSAYS ON HUMAN RIGHTS AND THEIR POLITICAL GUARANTEES (1845)).

[307] "How any given crime is to be punished cannot be settled by mere thinking; positive laws are necessary." G. HEGEL, PHILOSOPHY OF RIGHT 246 (1967).

c. Predictability in the Law

According to Dworkin, law as integrity is superior to conventionalism and pragmatism alike because it provides an acceptable compromise between the two conflicting requirements of a legal system, flexibility and predictability.[308] The dimension of value meets the flexibility requirement; the dimension of fit meets the predictability requirement that like cases be treated alike. But if predictability is a requirement of the law and this requirement is achieved only through coherence with institutional materials, then it can legitimately be objected that the Dworkinian model is not one for the law.

In reply, one must acknowledge that treating like cases alike is indeed desirable. What may be questioned, however, is that coherence with institutional materials is a necessary and sufficient tool to achieve this state of impartiality.[309] Indeed, the judicial interpretation of these materials remains uncertain since, as suggested earlier,[310] perfect objectivity in adjudication is impossible. Even assuming that the interpretation problem is eliminated, the possibility of conflict between fit and value in Dworkin's model still makes judicial outcomes uncertain.

In contrast, naturalistic adjudication provides all the predictability *that can possibly be provided* in an interpretive phenomenon such as adjudication. The use of the same external adjudicative standard of correspondence with our sense of justice in all cases will effectively cause all like cases to be treated alike. Divergence between past and present solutions will subsist in one of two situations: first, when past and present cases are not truly "like" cases; second, when past solutions are wrong from a natural law standpoint. In the first situation, the rule that like cases be treated alike simply does not apply; in the second situation, treating like cases alike is undesirable, for it would amount to repeating past mistakes.

It seems, therefore, that under a model of judicial reasoning akin to natural law, a just order will result spontaneously; when

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[308] *See supra* Subsection I.A.3.b.

[309] Roscoe Pound acknowledges the failure of institutional materials to provide "real, as distinguished from an illusory, certainty." Pound, *supra* note 71, at 655.

[310] *See supra* text accompanying notes 125-31.

desirable, consistency among judicial outcomes will simply emerge from the adjudicative process. But using consistency as a goal in itself would lead to undesirable results.

Conclusion

In order to articulate an externalistic model of judicial reasoning, it is useful to look at the method used in the sciences to discover natural physical laws. After deeper scrutiny, the model of judicial reasoning elaborated by Dworkin proves methodologically similar to Popper's model of scientific knowledge. Like scientific knowledge, judicial reasoning is evolutionary: it proceeds from error elimination rather than from a quest for certainty. Like scientific observation, judicial interpretation is not entirely value-free. But the division between the interpretor's subjective dispositions and the objective data interpreted is sufficient to allow for the subjective and objective components of the interpretive process to check and balance each other. From this phenomenon of checks and balances, judicial, like scientific, knowledge comes closer to the truth.

However, an important difference between the Dworkinian and Popperian models lies in the standard adopted for testing theories. In the Dworkinian model, legal rules, or principles, ought to pass a twofold test of fit and value. The dimension of fit implies a coherence theory of truth and makes the model internalistic. In contrast, a correspondence theory of truth provides the testing standard in the Popperian model, consequently making that model externalistic. It has been argued that this divergence from the Popperian model reveals an inconsistency in Dworkin's thesis. Because there is no possible middle ground between externalism and nihilism, the Dworkinian model of judicial reasoning, once corrected to accord with Popper's scientific model, becomes externalistic.

Two important questions have been ignored in this essay. First, the nature, source, and content of external adjudicative standards was not addressed. Natural law was used merely as an example. Second, the theoretical possibility of externalistic adjudication does not necessarily establish its practical desirability. It may be, for example, that the practical risk of judicial tyranny is too high for the model to be actually implemented. Or would

rightness be desirable regardless of the costs involved in its practical implementation? It is hoped that this essay has succeeded in demonstrating the importance of these issues for future examination.

LENDER LIABILITY IN MISSISSIPPI: PART II LOAN COMMITMENTS AND AGREEMENTS

*Robert C. Williamson, Jr., and Brenda Tanner Redfern**

Over the last four years some of the largest verdicts awarded in the United States involved lender liability claims.[1] Not surprisingly, these verdicts have inspired an explosion of copycat suits[2] and a multitude of articles and treatises by legal scholars and commentators.[3]

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[1] According to one source, in 1987 six of the ten largest verdicts awarded at trial involved lender liability claims. In each case the verdict exceeded $55 million. 2 Lender Liability L. Rep. 2 (Aug. 1988).

[2] *See* Victor, *Lender Liability Doctrine Gives Creditors Clout*, Nat'l L.J., Sept. 1, 1986, at 1, col. 2.

[3] *See, e.g.*, B. Capello & F. Komoraske, Lender Liability (1988)(discussing lender liability); J. Norton & W. Baggett, Lender Liability Law & Litigation (1989)(same); Anderson, *Lender Liability Under Basic Principles of Contract Law*, 43 Consumer Fin. L.Q. Rep. 8 (1989)(discussing prevailing contract theories of lender liability); Dennis & Endler, *Bank of America and Penthouse: Is the Lender Liability Pendulum Swinging Back?*, 43 Consumer Fin. L.Q. Rep. 3 (1989)(discussing changing judicial attitudes regarding lender liability); Dickens, *Equitable Subordination and Analogous Theories of Lender Liability: Toward a New Model of "Control,"* 65 Tex. L. Rev. 801 (1987)(discussing expansion of lender liability); Ebke & Griffin, *Good Faith and Fair Dealing in Commercial Lending Transactions: From Covenant to Duty and Beyond*, 48 Ohio St. L.J. 1237 (1989) (discussing court decisions imposing liability for breach of obligation of good faith and fair dealing and analyzing their effect on commercial lending transactions);

In an earlier article the authors surveyed the legal theories relied upon by borrowers and creditors in lender liability cases and analyzed the viability of those theories under Mississippi law.[4] The authors concluded that Mississippi courts ordinarily

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Ellis & Gray, *Lender Liability for Negligently Processing Loan Applications*, 92 DICK. L. REV. 363 (1988) (discussing potential lender liability in processing loan applications); Goldberg, *Lender Liability and Good Faith*, 88 B.U.L. REV. 653 (1988)(discussing imposition of lender liability through establishment of higher standard of skill and care on lenders); Hancock, *Creditor-Debtor Liability*, 4 CORP. COUNS. Q. 1 (1988)(general discussion of lender liability); Hass, *Insights into Lender Liability: An Argument for Treating Controlling Lenders as Controlling Shareholders*, 135 U. PA. L. REV. 1321 (1987) (arguing that same fiduciary duty imposed on controlling shareholders should apply to controlling creditors); Hillman & Caras, *When the Bank Wants Its Borrowers in Bankruptcy: Benefits of Bankruptcy for Lenders and Lender Liability Defendants*, 40 ME. L. REV. 375 (1988)(discussing possible benefits of debtor bankruptcy to avoid lender liability); Hinerfeld, *Now It's Lenders Who Must Beware*, 7 CAL. L. 61 (1987)(discussing growth of lender liability); Johnson & Gaffney, *Lender Liability: Perspectives on Risk and Prevention*, 105 BANKING L.J. 325 (1988)(practice pointers); Jones, *Good Faith Theories of Lender Liability*, 48 LA. L. REV. 1181 (1988)(discussing good faith theories of lender liability); Kratovil, *Mortgage Lender Liability—Construction Loans*, 38 DE PAUL L. REV. 43 (1988)(discussing imposition of higher standard of skill and care on lenders); Lawrence & Wilson, *Good Faith in Calling Demand Note and in Refusing to Extend Additional Financing*, 63 IND. L.J. 825 (1988)(addressing decisions concerning good faith in calling demand notes); Marhle & Fylstra, *Limiting Lender Liability Exposure*, 23 ARIZ. B.J. 8 (1988)(overview of lender liability actions for breach of commitment to lend and breach of contract in terminating existing lending relationship, advising lawyers to be aware that client's potential tort liability is much narrower and more devastating); Martin & Miller, *Creditor Control and Lender Liability*, 16 COLO. LAW. 1931 (1987) (discussion of lender liability theories, noting success of plaintiff/borrowers); Murphy, *An Introduction to the Defense and Prevention of Lender Liability Claims*, 4 PRAC. REAL EST. LAW. 41 (1988)(review of trend showing increase in lender liability cases on various theories); Neppl, *Lender Liability Under a Workout Agreement: A View Toward a More Balanced Approach*, 8 N. ILL. U.L. REV. 505 (1988) (suggesting better balancing approach between work-out agreement parties by imposing fiduciary relationship at inception of control relationship); Note, *The Growth of Lender Liability: An Economic Perspective*, 21 GA. L. REV. 723 (1987)(dealing with extra contractual obligations placed upon lenders when borrowers default and lenders pursue return of principal); *Lender Liability: Changing or Enforcing the Ground Rules*, 33 S.D.L. REV. 387 (1988) (lender liability cases warn creditors of need for fairness in relationship with creditors); West & Haggerty, *The "Demandable" Note and the Obligation of Good Faith*, 21 U.C.C. L.J. 99 (construction of demand notes); Note, *The Doctrine of Lender Liability*, 40 U. FLA. L. REV. 165 (1988)(examining theories of lender liability); Jersey Shore State Bank v. United States: *Lender Liability and Notice—When a Summons Is Enough*, 7 VA. TAX REV. 179 (1987)(lender not entitled to notice of tax assessment); Solosky, *Of Good Faith and Fair Dealing: A Tort Is Expanded to the Banks*, Nat'l L.J., Oct. 24, 1988, at col. 22 (expansion of lender liability tort and factors used by courts to determine whether to hold lender liable for implied covenant of good faith and fair dealing).

[4] Williamson & Tanner, *Lender Liability in Mississippi: A Survey, Comparison and*

should reject theories of liability which restrict the lenders' ability to enforce their loan agreements as written. The loan agreement and related documents reflect the allocation of risks the parties have agreed upon. Therefore, absent fraud or similar misconduct, courts should not rearrange the risk allocation agreed upon by the parties.[5]

In this article, the authors focus on practice, rather than legal theory. More specifically, this article addresses lender liability concerns associated with making, negotiating and drafting loan commitments and agreements. Section I discusses loan applications and commitments. Section II discusses specific types of credit facilities. Section III discusses general loan provisions.

In approaching these subjects, the authors are keenly aware that "the only generality about the lending of money to businesses that may be made with certainty is that it allows of almost no generalities."[6] Accordingly, no attempt is made to identify every legal issue that can arise in the negotiation and documentation of a loan commitment or agreement. The focus is on a few selected issues that might result in a liability claim against a lender.[7] Better loan documentation is not a panacea

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Comment, 57 MISS. L.J. 1 (1987).

[5] *Id.* at 84. To identical effect, another author observed:

> The complexities of commercial lending necessitates individualized solutions. Demand notes, due-on-sale clauses, and other provisions that move away from a strict rule of reasonable belief in a loan's insecurity are tools by which lenders and borrowers reach agreement; they represent an agreed-upon allocation of risks in a complicated market. When courts limit the flexibility with which these tools may be used, parties must live with inefficient allocations of risks and benefits. Further, the costs to all contracting parties are likely to become more uniform. To the extent that lenders are unable to distinguish between good and bad risks at the time of contract formation, cross-subsidization will ensue. As all borrowers are offered similar lending terms, lower risk borrowers, who under a more flexible system might achieve more favorable terms, are in effect subsidizing higher risk borrowers, who might be subject to discretionary demand or default provisions in a world without court-imposed terms.

Synderman, *What's So Good About Good Faith? The Good Faith Performance Obligation in Commercial Lending*, 55 U. CHI. L. REV. 1550, 1570 (1988).

[6] Synderman, *supra* note 5, at 1559.

[7] This paper will not address many other issues that are pertinent to lenders, such as usury, securities laws and anti-trust laws. For authorities dealing with these subjects, see Williamson & Tanner, *supra* note 4, at 3 n.11. Provisions which have resulted in losses to lenders but which have not been the subject of suit against the lender are not addressed. For example, if the lender has an incorrect name for the borrower on the loan

for lender liability concerns because even a perfectly drafted loan agreement will not guarantee the lender immunity from suit. The lender's conduct will weigh heavily in the formula. During every stage of the loan process the lender should assume that its conduct *will* be brought to the attention of a jury if an action develops related to the loan.

I. Loan Commitments and Applications

A. Loan Commitments

A loan commitment is a promise to loan money; usually the commitment is made in writing.[8] Often the lender charges the borrower a fee for issuing the commitment.[9]

Lender liability for loan commitments usually revolves around two central questions: Did the lender's statements to the borrower create a legally enforceable obligation?[10] If so, did the borrower comply with the conditions of the commitment?[11] When both questions have been answered in the affirmative, courts have not hesitated to impose liability on the lender for breach of its commitment. Some of the most spectacular lender

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documents, a loss of priority to the collateral securing the loan may result, especially if the priority is based upon the filing of a U.C.C. financing statement. Although this problem would result in a loss to the lender, it generally would not result in a suit against the lender by the borrower. Of course, based on the particular circumstances, the lender might be sued for such errors (for example, if the loan was guaranteed by a third party).

Another developing area of liability law not directly addressed is lender liability for construction loans. For authorities dealing with this subject, see G. Nelson & D. Whitman, Real Estate Finance Law §§ 12.4, 12.6, 12.7, 12.10, 12.11 (2d ed. 1985); Reitz, *Construction Lender's Liability to Contractors, Subcontractors and Materialmen*, 130 U. Pa. L. Rev. 416 (1981); Stephenson & Mitchell, *Recovery from Construction Lenders*, 89-3 Construction Briefings (1989).

[8] G. Nelson & D. Whitman, *supra* note 7, at 845. This treatise contains an excellent overview of mortgage loan commitments. *Id.* at 845-60.

[9] *Id.* at 850. A commitment fee is akin to the fee paid to secure an option to purchase real estate. It is consideration for the lender's promise to loan money at a future date. Levenson v. Barnett Bank, 330 So. 2d 192, 194 (Fla. Dist. Ct. App. 1976). When a borrower fails to exercise the commitment, the commitment fee may usually be kept by the lender as a form of liquidated damages unless the terms of the commitment itself provide for a refund. G. Nelson, *supra* note 7, at 851-52. Commitment fees are distinguishable from loan application charges made by the lender to cover the expense of processing the loan application. *Id.* at 850.

[10] *See infra* notes 13-62 and accompanying text (discussing enforceability).

[11] *See infra* notes 63-89 and accompanying text (discussing compliance).

liability verdicts in favor of borrowers have arisen from lenders' failure to honor their commitments.[12]

1. Enforceability of Commitment

Disputes frequently arise between lenders and borrowers over whether statements made by the lender created a binding loan commitment or merely invited further negotiation pending execution of formal loan documents. A fundamental tenet of contract law is that a bargain is not enforceable unless its terms are reasonably certain.[13] Applying this rule strictly, some courts refuse to enforce promises to loan money which contemplate the execution of more formal documents at a later date unless the circumstances establish all the essential terms of the bargain and further establish that the formal loan documents were intended to memorialize, not supplement, the parties' bargain.[14] Under this approach, "a 'contract to make a contract' is not a contract at all if any material term is left open for future settlement."[15]

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[12] *See, e.g.*, Landes Constr. Co. v. Royal Bank, 833 F.2d 1365, 1367 (9th Cir. 1987) ($18.5 million verdict); Scharenberg v. Continental Ill. Nat'l Bank & Trust, No. 84-2712-CIV-Davis; No. 87-0211-CIV-Davis; No. 87-0238-CIV-Davis (S.D. Fla. 1987), *reported in* 1 LENDER LIABILITY L. REP. 4 (Aug. 1987) ($105 million); MBank Abilene, N.A. v. LeMaire, No. C14-86-00834-CV (Tex. Ct. App. April 6, 1989) (LEXIS, States library, Tex. file) ($69 million; reduced to $18.5 million on appeal).

[13] A leading treatise on contract law states:

> We have already seen that indefiniteness in a communication would be some evidence of an intent not to contract. The more terms that are omitted the more likely it is that the parties do not intend to contract. But even if the parties intend to contract, if the content of their agreement is unduly uncertain, no contract is formed. This rule must be understood as a necessary limitation upon freedom of contract because an agreement must be sufficiently definite before a court can enforce it. The traditional rule is that if the agreement is not *reasonably* certain as to its *material* terms there is a fatal indefiniteness with the result that the agreement is void.

J. CALAMARI & J. PERILLO, CONTRACTS 53 (3d ed. 1987) (emphasis added).

[14] In addition to the cases in the text, see John Deere Co. v. Short, 378 S.W.2d 496, 503 (Mo. 1964) (commitment too indefinite where amount, date loan to be made, due date and security omitted); Labor Discount Center, Inc. v. State Bank & Trust Co., 526 S.W.2d 407, 425 (Mo. Ct. App. 1975) (commitment too indefinite where due date, security, rate of interest and time for payment omitted); Union State Bank v. Woell, 434 N.W.2d 712, 717 (N.D. 1989) (commitment too indefinite where amount, interest and terms omitted).

[15] Mid-Continent Tel. Corp. v. Home Tel. Co., 319 F. Supp. 1176, 1188 (N.D. Miss.

A leading case following this approach is *J. Russell Flowers, Inc. v. Itel*,[16] a federal district court decision applying Mississippi law. In *Flowers*, the lender and a borrower signed a letter outlining the terms the lender was "pleased to offer"[17] to finance the lease of forty-five river barges. The letter contained a provision stating, "[F]inancing is firm, however, it will be reduced to a more definitive document within 30 days."[18] When the parties were unable to agree on the terms of an operating lease, the prospective borrowers sued, contending that the lender was bound by the financing terms outlined in the letter signed by the parties. The court disagreed, holding that the letter did not create a contract since it addressed only the question of financing and "openly contemplated"[19] negotiating the other lease terms at a later date.[20]

A similar result was reached in *Willowood Condominium Association, Inc. v. HNC Realty Co.*[21] In that case, the developers of a condominium project contended that two letters sent them by the lenders created a binding commitment. The first letter set forth the terms upon which a loan would be made if approved by the loan committee. The second letter recited that the loan committee had acted favorably on the loan subject to three inconsequential changes.[22] The court rejected the developers' contentions because essential terms were left open for future negotiations; such essential terms included how and when a floating interest charge would be paid, the loan closing date, the method of making construction advances, the name of the to-be-formed corporate borrower, and the terms of the contemplated mortgage.[23]

In *Lencioni v. Brill*,[24] the court refused to order specific performance of a real estate contract requiring the sellers to furnish

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1970).

[16] 495 F. Supp. 88 (N.D. Miss. 1980).

[17] *J. Russell Flowers*, 495 F. Supp. at 89.

[18] *Id.*

[19] *Id.* at 91-92.

[20] *Id.*

[21] 531 F.2d 1249 (5th Cir. 1976).

[22] *Willowood Condominium Assoc., Inc.*, 531 F.2d at 1250.

[23] *Id.* at 1251-52.

[24] 50 Ill. App. 3d 802, 365 N.E.2d 1169 (1977).

a standard form mortgage at closing on the grounds that the meaning of "standard form mortgage" was too indefinite to enforce.[25]

Other courts take a more flexible approach to the issue of contract certainty. In *Sterling Faucet Co. v. First Municipal Leasing Corp.*,[26] the court found that a letter which "announce[d] the commitment of funds . . . for the leasing of certain equipment"[27] was a binding contract and not a mere invitation to bid. The letter identified the parties, the amount and terms of the loan, and the closing conditions.[28] The trial court rejected the lender's contention that the letter was a mere negotiation[29] intended only as a non-binding proposal.[30]

In *999 v. C.I.T. Corp.*,[31] the borrower asked a lender to finance his acquisition of another company. The lender delivered a letter to the borrower requesting a loan application and a $25,000 deposit. At the borrower's request, the lender outlined in longhand on the letter the terms of the proposed financing arrangement.[32] A month later, the lender notified the borrower that the loan would also be conditioned on a $25,000 prepayment penalty. The borrower refused to accede to this condition, demanded the return of its deposit and sued the lender.[33] The trial court upheld a substantial verdict against the lender on the grounds that the lender had breached its duty of good faith and fair dealing in demanding that the borrower accept the prepayment penalty clause.[34]

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[25] *Lencioni*, 365 N.E.2d at 1172.

[26] 716 F.2d 543 (8th Cir. 1983).

[27] *Sterling Faucet Co.*, 716 F.2d at 543-44.

[28] *Id.*

[29] *Id.*

[30] *Id.*; *see* Weissman, *Lender Liability: The Obligation to Act in Good Faith and Deal Fairly*, 69 J. COM. B. LENDING 2 (1986), *reprinted in* IV ABA EMERGING THEORIES OF LENDER LIABILITY 179, 181 (H. Chaitman ed. 1987) (reporting on trial court's decision).

[31] 776 F.2d 866 (9th Cir. 1985).

[32] *C.I.T. Corp.*, 776 F.2d at 868.

[33] *Id.*

[34] *Id.* In an interesting twist, a borrower was held liable to a lender for refusing to accede to a default prepayment provision in Teachers Ins. & Annuity Ass'n v. Butler, 626 F. Supp. 1229 (S.D.N.Y. 1986). The lender issued a commitment to a limited partnership for the permanent financing of a high-rise office building. *Id.* at 1230. During construc-

The courts are also sharply divided on the application of the definiteness requirement when the commitment is oral rather than written. In *Champaign National Bank v. Landers Seed Co.*,[35] the court reversed a jury's finding that a lender had breached an oral commitment to roll over a six-month note so long as the borrower made "progress toward profitability."[36] The court recognized that oral contracts to lend are enforceable, but held the duration of the alleged commitment was too vague to enforce.[37]

In *Kruse v. Bank of America*,[38] the court reversed a $46 million verdict in part because an alleged oral commitment to provide long term financing for an apple-processing plant was too indefinite, finding that none of the essential terms of the loan had been agreed upon.[39] The borrowers initially sought financing for the plant from Bank of America. When their initial application was denied, the borrowers obtained interim construction financing from the Production Credit Association (PCA), but continued to seek long-term financing from Bank of America.[40] The

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tion, interest rates dropped dramatically. *Id.* at 1232. The commitment contained a provision requiring the borrower to pay a premium for prepayment of the loan. The commitment did not expressly provide, however, for a prepayment penalty if the borrower defaulted, the lender accelerated and the borrower tendered all sums due prior to foreclosure. Fearing the partnership might attempt to evade the prepayment premium through a voluntary default, the lender included a provision in the final loan documents providing that any tender prior to a foreclosure sale would be deemed an evasion of the prepayment premium and would trigger its operation. *Id.* at 1230. When the partnership refused to accept or negotiate this provision, the lender sued for breach of the commitment and won a multimillion-dollar judgment against the partnership and its general partners. *Id.* at 1236. The court acknowledged that the commitment "did not contain, and the parties understood that it did not contain, all the final and definite terms that were to be incorporated in the closing documents." *Id.* at 1232. The court held the partnership had breached an implied duty to negotiate the loan documents in good faith since the default prepayment provision was necessary to enforce the prepayment provision in the commitment, and the commitment required the partnership to consent to all matters the lender's attorneys found "reasonably necessary for the transaction." *Id.* at 1234-35.

[35] 165 Ill. App. 3d 1090, 519 N.E.2d 957 (1988).

[36] *Champaign Nat'l Bank*, 519 N.E.2d at 959-60.

[37] *Id.* The duration of the loan was indeterminable. *Id.* at 960.

[38] 202 Cal. App. 3d 38, 248 Cal. Rptr. 217 (1988).

[39] *Kruse*, 248 Cal. Rptr. at 228-29; *see also* Stansel v. American Sec. Bank, 547 A.2d 990, 993 (D.C. App. 1988) (no evidence of alleged terms of loan).

[40] *Kruse*, 248 Cal. Rptr. at 221.

bank's loan officer was enthusiastic about the likelihood of securing the requested financing. The borrowers knew the officer lacked authority to approve the loan himself but concluded the loan would be approved because the loan officer's supervisor stated, "We're going to be able to help [you]."[41] During the course of construction, Bank of America and PCA provided additional financing for equipment needed for the new plant.[42] Nevertheless, Bank of America ultimately decided not to provide the long-term financing sought by the borrowers.[43] The court concluded that no enforceable loan commitment had been made because the borrowers knew the loan officer lacked authority to bind the bank[44] and because none of the essential terms of the contemplated loans—amount, interest, terms of repayment and loan fees—were agreed upon.[45]

Other courts have taken a more liberal approach to oral commitments. In *National Farmers Organization v. Kinsley Bank*,[46] the lender breached an oral promise to finance the borrower's purchase of several thousand lambs. The lender financed the down payment for the lambs; but when the borrower attempted to draw additional money to pay for the delivery of the first truckloads, the lender dishonored the borrower's checks and told the borrower it could not lend him any additional money because doing so would exceed its institutional loan limit.[47] The

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[41] *Id.* at 221-22.

[42] *Id.* at 222.

[43] *Id.* at 222-23.

[44] *Id.* at 229. The court stated, "Here, the entire subject matter under consideration —the long term loan—was at best open to future negotiation and agreement. . . . The Jewells' hopeful expectation that a loan agreement would eventually be reached was simply that: an expectation." *Id.*

[45] *Id.* at 229-30. The borrowers sought financing with the plant as security for the loan. Two of the borrowers also alleged the bank had agreed alternatively to provide financing with the ranch as security. The court's discussion of indefiniteness referred to this alleged commitment, but was applicable to both. *Id.* at 230.

[46] 731 F.2d 1464 (10th Cir. 1984).

[47] *National Farmers Org.*, 731 F.2d at 1467. The courts disagree over whether a borrower may sue a lender for breach of a commitment to lend money in excess of a bank's legal lending limits. *Compare* Jaynes v. First Nat'l Bank, 236 F.2d 258, 259 (9th Cir. 1956) (unenforceable) *with* MBank Abilene v. LeMaire, No. C14-86-00834-CV (Tex. Ct. App. April 6, 1989) (LEXIS, States library, Tex. File)(enforceable). 12 U.S.C. § 84 places a ceiling on the amount a national bank may lend to any one customer. *Id.* The Comptroller of the Currency promulgates regulations implementing this statute and set-

lender argued that its commitment was not enforceable because the parties had not agreed on essential terms, including the exact amount of the loan, the interest rate, or prepayment terms.[48] The court disagreed, reasoning that the approximate amount of the needed loan was known and that the open terms could be determined by reference to standard commercial practice and custom.[49]

In *Landes Construction Co. v. Royal Bank*,[50] the lender breached an oral promise to finance the borrowers' purchase of eleven acres of land in Los Angeles. The commitment was made during two meetings between the borrowers and a bank officer. The only terms agreed upon were the amount of the loan, the interest rate, the bank's fee, and the requirement that the borrowers personally guarantee the loan.[51] Essential terms such as the manner of repayment were not agreed upon.[52] Nevertheless, the lender advanced money for the project under an existing line of credit one of the borrowers had with the bank.[53] Soon thereafter, the borrowers presented an application for new financing to cover debt service on the acquisition loan and the costs of developing the property, but the bank rejected this application. Unable to arrange additional financing, the borrower sued. The court held that the bank had made an enforceable commitment and affirmed an $18.5 million verdict for the borrower.[54]

In *MBank Abilene, N.A. v. LeMaire*,[55] the lender dishonored an oral promise to finance the borrowers' oil and gas drilling program.[56] Although the amount of the promised loan exceeded the lender's legal loan limit, the bank expected to be able

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ting forth the circumstances under which two or more borrowers should be treated as one for purposes of the lending limit. *Id.*

[48] *National Farmers Org.*, 731 F.2d at 1469-70.

[49] *Id.* at 1476.

[50] 833 F.2d 1365 (9th Cir. 1987).

[51] *Landes Constr. Co.*, 833 F.2d at 1368-69.

[52] *Id.*

[53] *Id.* A similar arrangement had been utilized on an earlier transaction until the bank's paper work for the project was completed. *Id.* at 1369.

[54] *Id.* at 1375.

[55] No. C14-86-00834-CV (Tex. Ct. App. April 6, 1989) (LEXIS, States library, Tex. file).

[56] *MBank Abilene*, No. C14-86-008340-CV, at 2-5.

to fund the commitment by securing the participation of other lenders.[57] A down-turn in the energy industry, financial problems within the bank, and a cease and desist order issued by the Comptroller of the Currency prohibiting loans in excess of the bank's lending limit prevented the bank from carrying out its plan.[58] The borrowers sued for breach of an oral promise to lend, and a jury entered a multimillion dollar verdict against the bank.[59] On appeal the court held that the borrowers' claim for breach of contract was barred by the Texas statute of frauds.[60]

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[57] *Id.* at 3.

[58] *Id.* at 4-5.

[59] *Id.* at 2. The jury assessed damages at over $100 million; the trial court reduced this verdict to $69 million.

[60] *Id.* at 26. The applicable statute dealt with contracts involving an interest in land. *Id.* (citing TEX. BUS. & COMM. CODE § 26.01 (1988)). Since oil and gas properties were to be used as collateral for the loan, the court held the agreement was subject to the statute. *Id.* In *Landes Constr. Co.*, the court concluded that the borrowers' agreement to grant a lien against certain real property was within the statute of frauds but that the lender's oral agreement to lend the borrowers the money to purchase the property was not. *Landes Constr. Co.*, 833 F.2d at 1370.

MISS. CODE ANN. § 15-3-1(c) (1972) requires all contracts for the sale of land to be in writing in order to constitute an enforceable agreement. *Id.* The writing requirement is also applicable to agreements to answer for the debt or default of another party, *id.* § 15-3-1(a), and to loan commitments that are not to be performed within 15 months of the date of agreement, *id.* § 15-3-1(d). In construing the latter provision, the Mississippi Supreme Court held in United States Fin. Co. v. Barber, 247 Miss. 800, 810, 157 So. 2d 394, 397 (1963), that an agreement falls within the 15-month exception to the statute only if it conclusively negates the right to perform within that period of time.

Mississippi recognizes several exceptions to the statute of frauds. The statute of frauds does not apply to oral commitments where there has been complete performance of the agreement by both parties. *See* Beane v. Bowden, 399 So. 2d 1358, 1361 (Miss. 1981)(statute of frauds did not bar enforcement of oral joint venture agreement where both parties had substantially performed). Nor will it apply where the doctrine of equitable estoppel applies. *See* Shogyo Int'l Corp. v. 1st Nat'l Bank, 475 So. 2d 425, 428 (Miss. 1985)(equitable estoppel applicable where lender misrepresented to import company its intent to guarantee purchases made by manufacturer); PMZ Oil Co. v. Lucroy, 449 So. 2d 201, 206 (Miss. 1984)(where elements of equitable estoppel are present, statute of frauds constitutes no bar to enforcement of that to which party has agreed). *But see* Thomas v. Prewitt, 355 So. 2d 657, 661-62 (Miss. 1978)(under circumstances outlined equitable estoppel not exception to statute of frauds). The Mississippi Supreme Court has made apparently inconsistent statements concerning whether the doctrine of promissory estoppel is an exception to the statute of frauds. *Compare* Sanders v. Dantzler, 375 So. 2d 774, 776 (Miss. 1979)(apparently recognizing doctrine of promissory estoppel as exception) *with* Martin Anderson Constr. Co., Inc. v. Lyon Metal Prod., Inc., 370 So. 2d 935, 937 (Miss. 1979)(not exception) *and* Martin v. Franklin, 245 So. 2d 602, 604-05 (Miss. 1971)(same).

Nevertheless, the court affirmed $12.5 million of the jury's verdict under a promissory estoppel exception to the statute.[61] The bank argued that the terms of its promise were too indefinite to enforce and that the parties contemplated executing formal loan documents and security agreements before any binding obligation arose. The court found, however, that the missing terms could be inferred from the past "extensive and repetitious course of dealings between the parties."[62]

The Mississippi Supreme Court appeared to recognize past performance as an exception to the statute of frauds in Pugh v. Gressett, 136 Miss. 661, 101 So. 691 (1924). The plaintiff was a director and managing officer of a corporation in which he owned 20 shares. *Id.* Plaintiff alleged he entered into an agreement with defendants whereby plaintiff would turn over management of the corporation and his 20 shares therein in exchange for $10,000. *Id.* at 674, 101 So. at 692. It was agreed and understood by all parties that the written contract would be drafted and executed at a later date. *Id.* at 675, 101 So. at 692. Plaintiff subsequently turned over control of the corporation to defendants on the assurance that payment for the stock was forthcoming; when no such payment was made, plaintiff filed suit to recover the $10,000. *Id.* at 677-78, 101 So. at 693. In affirming the trial court's ruling in favor of the plaintiff, the Mississippi Supreme Court held that the oral agreement between the parties did not come within the statute of frauds because surrender of control and management of the corporation by the plaintiff and acceptance of the same by the defendants constituted such a part performance of the agreement as to make the statute inapplicable. *Id.* at 683-84, 101 So. at 695. The court further noted that the agreement was not merely one for the sale and purchase of stock, but rather was primarily motivated by a desire for change in the control and management of the corporation. *Id.* Defendant's acceptance of the stock along with plaintiff's relinquishment of control and management of the corporation was inconsistent with his position that the agreement was unenforceable under the statute of frauds. *Id.* The court distinguished *Pugh* and closed the door on this exception, however, in Howell v. Buford, 218 So. 2d 859 (Miss. 1969). In *Howell*, plaintiff and defendants executed a $10,000 note on which suit was brought. *Id.* at 860. Defendants asserted as a setoff to the note an indebtedness allegedly owed to them by the plaintiff under an oral agreement which required the plaintiff to purchase fertilizer. *Id.* at 861. In refuting assertions that the oral agreement was excepted from the statute of frauds by the defendants' partial performance, the court stated that part performance does not constitute an exception where such performance results in only an indirect benefit to the nonperforming party and where the nonperforming party's acceptance of performance does not inherently imply an admission that an oral agreement does in fact exist. *Id.* at 862.

[61] *MBank Abilene*, No. C14-86-00834-CV, at 1.

[62] *Id.* at 20-22. The court observed that the commitment "was not made in a vacuum, but against a rich background of virtually identical loans." *Id.* at 21. The court emphasized it was not holding that prior dealings ordinarily can be used to supply missing terms, but noted "[w]e simply take actors at their word when their long established practice faces the significance of ordering 'the usual.' " *Id.* at 21-22. For another case in which an oral commitment to lend was found potentially enforceable, see Davis v. First Interstate Bank, 115 Idaho 169, 765 P. 2d 680, 681 (1988)(oral commitment by lender to

2. Compliance with Commitment

Assuming an enforceable commitment to lend, lender liability turns upon whether the borrower complied with the terms of the commitment. If a lender refuses to honor its commitment or conditions its willingness to provide the promised loan on terms not contained in its commitment, the lender commits an anticipatory breach of contract.[63] To recover for the breach, however, the putative borrower must have had the ability to perform its own obligations under the commitment.[64]

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advance funds to prevent sheep from starving).

[63] *See infra* notes 65-89 and accompanying text (discussing anticipatory repudiation). As one commentator observed:

> If one party to a contract, either willingly or by mistake, demands of the other a performance to which he has no right under the contract and states definitely that, unless his demand is complied with, he will not render his promised performance, an anticipatory breach has been committed. Such a repudiation is conditional in character, it is true; but the condition is a performance to which the repudiator has no right . . . .

4A CORBIN, CORBIN ON CONTRACTS § 973, at 910-11 (1951); *see also* REA Express, Inc. v. Interway Corp., 538 F.2d 953, 955 (2d Cir. 1976) (refusal to perform based upon erroneous construction of conditions precedent); Neal-Cooper Grain Co. v. Texas Gulf Sulphur Co., 508 F.2d 283, 288 (7th Cir. 1974) (defendant argued document never ripened into contract because never accepted by corporate headquarters as expressly required by document); 2 RESTATEMENT (SECOND) OF CONTRACTS § 250, comment (1981) (if nonperformance constitutes total breach, then party commits repudiation if he refuses to perform duty in mistaken belief performance is not required).

The above quoted rule is subject to an important caveat. A refusal to perform must be clear and unequivocal. Consequently, "[d]oubtful and indefinite statements that performance may or may not take place and statements that, under certain circumstances that in fact do not yet exist, the performance will not take place," 4A CORBIN, *supra*, § 973, at 905, do not constitute an anticipatory breach, *id.* Any other rule would result in a claim of repudiation every time one party disagreed with the other party's interpretation of the contract.

[64] *See infra* notes 76-89 and accompanying text (discussing requirements for recovery). Repudiation relieves the injured party of its duty to perform or to tender performance. 2 RESTATEMENT, *supra* note 63, § 277; 4A CORBIN, *supra* note 63, § 977. To recover for an anticipatory breach, however, the injured party must demonstrate its willingness and ability to perform its own obligations under the contract at the time of the breach:

> In an action for breach by unconditional repudiation it is still a condition precedent to the plaintiff's right to a judgment for damages that he should have the ability to perform all such conditions. If he could not or would not have performed the substantial equivalent for which the defendant's performance was agreed to be exchanged, he is given no remedy in damages for the defendant's non-performance or repudiation. Of course, the willingness and ability that remains a condition precedent in spite of the defendant's repudiation is

Two recent decisions illustrate the operation of these principles. In *United California Bank v. Prudential Insurance Co.*,[65] the court affirmed an $11.3 million judgment against Prudential Insurance Company (Prudential) for breach of a commitment to provide long term financing for a high-rise hotel developed by HRP Hotel Company (HRP).[66] HRP's loan application, submitted on a form prepared by Prudential, conditioned Prudential's obligation on HRP's providing Prudential with a first mortgage on the hotel and incorporated by reference a rider setting forth a number of other conditions.[67] After further discussion between the parties, Prudential issued a commitment letter. The letter incorporated a modified list of the conditions contained in the rider but did not mention the terms set forth in the application.[68] One of the listed conditions required HRP to provide title insurance insuring Prudential's lien. Arrangements to obtain this insurance at closing were made by the lender's providing the interim construction financing for the hotel.[69]

Prior to closing, construction liens were filed against the hotel by the general contractor for the project and certain of its subcontractors.[70] Under the law in that jurisdiction, these liens took priority over mortgage liens filed after construction began.[71] Prudential refused to close the loan unless HRP satisfied the liens, contending that HRP's application, which required delivery of a first mortgage, was part of HRP's obligation. Disagreeing, HRP sued.[72]

The court concluded that since the application was not incorporated into Prudential's commitment letter Prudential had

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willingness and ability to perform if there had been no repudiation.

Id. § 978, at 924-25; *see, e.g.*, Woliansky v. Miller, 135 Ariz. 444, 661 P.2d 1145, 1147 (Ariz. App. 1983) (where seller repudiates contract, purchaser not required to tender performance in order to preserve right to enforce contract); Bertrand v. Jones, 58 N.J. Super. 273, 156 A.2d 161, 168 (1959) (citing CORBIN).

[65] 140 Ariz. 238, 681 P.2d 390 (Ariz. App. 1983).

[66] *United Cal. Bank*, 681 P.2d at 398.

[67] *Id.* at 399. The rider included an additional 34 conditions. *Id.*

[68] *Id.* at 399-400.

[69] *Id.* at 402.

[70] *Id.* at 403.

[71] *Id.* at 402.

[72] *Id.* at 403.

committed an anticipatory breach by insisting on a first mortgage.[73] Prudential argued that HRP failed to demonstrate it had the ability to perform, because a title policy had not in fact been issued prior to expiration of the commitment.[74] The court rejected this argument, finding that, under the terms of the commitment, the policy itself did not have to be issued until Prudential deposited its loan proceeds with the closing agent and that there was ample evidence indicating the policy would have been issued had Prudential honored its commitment.[75]

In *Penthouse International, Ltd. v. Dominion Federal Savings & Loan Association*,[76] the court reversed a $129 million verdict against Dominion Federal Savings & Loan Association (Dominion) for the alleged breach of a commitment to finance the development of a gambling casino and hotel for Penthouse International, Ltd. (Penthouse).[77] Dominion was a participant in a $97 million loan commitment made by Queen City Savings & Loan Association (Queen City) to Penthouse. The participation agreement designated Queen City lead lender for the loan participants and empowered Queen City to determine Penthouse's compliance with the terms of the commitment.[78] The commitment required that the loan be closed prior to the expiration date of the commitment, and the closing date was extended several times.[79] Counsel for Queen City and Penthouse ultimately agreed to close the loan "no earlier than February 1, 1984, or later than March 1, 1984."[80] The commitment was conditioned on Penthouse's meeting a number of requirements. Among other

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[73] *Id.* at 429-32. The court rejected Prudential's arguments that (1) the deed of trust and other collateral documents approved by the parties required a first lien, *id.* at 420-24; (2) the application and commitment constituted the contract, *id.* at 423-24; (3) marketable title was an implied obligation, *id.* at 426-27; and (4) its agreement to accept title insurance violated Arizona insurance statutes, *id.* at 427-28.

[74] *Id.* at 436. Prudential also unsuccessfully argued that HRP failed to prove its ability to make payment under certain contracts involving the hotel's operations and its ability to pay the construction lender. *Id.* at 439-41.

[75] *Id.* at 436-38.

[76] 855 F.2d 963 (2d Cir. 1988).

[77] *Penthouse Int'l, Ltd.*, 855 F.2d at 987. The court also reversed the trial court's ruling that Dominion's attorneys were jointly and severally liable with Dominion. *Id.*

[78] *Id.* at 967.

[79] *Id.* at 966.

[80] *Id.* at 968.

things, Penthouse was required to provide an insurable first mortgage on the casino, copies of construction plans and contracts, proof of utility services, and evidence of satisfactory alternative licensing if Penthouse could not secure a casino permit.[81] Representatives of Penthouse and Queen City met on several occasions to determine Penthouse's progress in meeting these conditions. Queen City agreed to waive or modify several of the conditions but did not consult with the other loan participants prior to agreeing to these changes.[82]

Dominion's counsel, Phillip Gorelick, attended a pre-closing conference in February, 1984. During that conference Gorelick declared that the loan could not close because Penthouse could not satisfy a number of the conditions in the commitment prior to its expiration. Gorelick demanded control of both the preparation of the closing documents and the monitoring of Penthouse's compliance with closing conditions. Penthouse and Queen City consented to this arrangement.[83] Shortly before the commitment expired, Gorelick notified Penthouse that an extension of the loan commitment was needed; but Penthouse failed to request an extension.[84] Nevertheless, Gorelick continued his work and the negotiations after the commitment expired. Penthouse concluded that Gorelick was imposing conditions not contained in the commitment and accordingly brought suit against Dominion for anticipatory breach.[85]

The trial court concluded that Dominion had repudiated the commitment by insisting on compliance with conditions which were not contained in the original commitment or which

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[81] *Id.* at 965-67.

[82] *Id.* at 968.

[83] *Id.* at 970. "Gorelick was less than tactful." *Id.* He characterized the draft closing documents prepared by Queen City's counsel as "idiotic." *Id.* The trial court concluded that Gorelick had been hired by Dominion to "sabotage the deal." Penthouse Int'l, Ltd. v. Dominion Fed. Sav. & Loan Ass'n, 665 F. Supp. 301, 308 (S.D.N.Y. 1987). Dominion's share of the loan commitment exceeded its institutional lending limit; so to bring the loan within its limits, Dominion entered into a subparticipation agreement with Community Savings and Loan Association (Community). *Id.* at 303. After entering into this agreement, Community began to express strong doubts about the loan and later withdrew. *Id.* at 306. The court concluded that Dominion also began to have second thoughts and hired Gorelick to extricate Dominion from the commitment. *Id.* at 306.

[84] *Penthouse Int'l, Ltd.*, 855 F.2d at 971.

[85] *Id.* at 972.

had been waived by Queen City.[86] The appellate court disagreed, ruling that the lenders' commitment expired on March 1, 1984, notwithstanding the parties' continued discussions. Accordingly, Gorelick's demands after that date were immaterial. Either Gorlick's demands before that date were consistent with the commitment, or they did not rise to the level of a clear and unequivocal repudiation of the commitment.[87]

The appellate court also held that Penthouse had not met its burden of proving it was able to perform at the time of the alleged repudiation. The court concluded that Queen City lacked authority to waive Penthouse's failure to comply with certain conditions of the commitment[88] and that Penthouse had failed to demonstrate its ability to comply with other material conditions of the commitment such as delivery of a valid first mortgage.[89]

3. Practice Observations

The cases discussed in this section demonstrate that often there is a fine line between a proposal and a contract. Accordingly, counsel need to take appropriate precautions to ensure that their clients' intentions are not misunderstood.

The first step is simple: state what is intended. Term sheets or preliminary proposals outlining the general terms of a financing arrangement should contain a very clear disclaimer to the effect that the document is intended to facilitate the parties' negotiations and is not intended to be a formal offer or acceptance or otherwise binding on either party. If the terms of a contemplated loan are discussed by phone or at a meeting, an oral disclaimer should be made. Ideally, a letter confirming the sub-

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[86] *Id.* at 973.

[87] *Id.* at 975-76.

[88] *Id.* at 981. Although Queen City had the "final word on whether the pre-closing conditions had been satisfied," *id.* at 981, the participation agreement did not authorize Queen City to waive the conditions and specifically recited that Queen City was not the participating lenders' agent. *Id.* at 981-82. Relying upon an amicus brief submitted by the Federal Home Loan Bank Board, the court observed that its decision was consistent with federal regulations requiring federally regulated lenders to make their own evaluations of the soundness of participating in a given loan transaction. *Id.*

[89] *Id.* at 983.

stance of the discussion and confirming the disclaimer should be sent to the borrower immediately after the oral communication. At a minimum the loan officers should make a file note about the conversation. This step is so critical that lenders should make it a mandatory procedure in their operations.

The next step is more painful: if no contract is intended, avoid commitment fees. Charging a *non-refundable* fee in excess of the lender's out-of-pocket expenses substantially increases the likelihood that a court will find that a binding commitment to lend has been made.[90] A commitment fee is akin to a real estate option fee—a payment to the lender to reserve funds for a borrower.[91] The safest approach is to limit the customer's obligation to reimbursing the lender for its out-of-pocket expenses such as attorney's fees, credit checks, appraisal fees, travel expenses and similar charges. If the lender decides to charge a fee that is not intended as consideration for committing to make a loan, the document should clearly label the nature of the fee (for example, application fee, structuring fee or syndication fee), state its purpose, and disclaim any intent to create a contract.

Oral promises to lend money are especially dangerous for lenders. If the terms of the promise are definite enough, they are enforceable. As reflected in *Landes* ($18.5 million verdict for borrower) and *LeMaire* ($12.5 million verdict for borrower), the consequences of enforcement can be devastating. Moreover, oral commitments may cause audit problems for bank examiners and may mislead the bank's shareholders if not properly reflected on financial statements.

If properly prepared, written loan commitments contain pre-closing conditions designed to protect the lender's position.[92]

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[90] Shaughnessy v. Mark Twain State Bank, 715 S.W.2d 944 (Mo. Ct. App. 1986)(discussed *infra* at notes 130-31).

[91] *See supra* note 9 (discussing commitment fees). Commitments can be unilateral or bilateral. In bilateral commitments, both parties are bound; the lender is obligated to make the loan and the borrower is obligated to borrow the money from the lender. In a unilateral commitment, the lender is bound, but not the borrower. Stated differently, the borrower has taken out an option. Most loan commitments are unilateral contracts. J. NORTON & W. BAGGETT, *supra* note 3, § 3.03[3].

[92] "Conditions precedent are those events specified in the commitment agreement which must occur before execution of the commitment is required of the lender." J. NORTON & W. BAGGETT, *supra* note 3, § 3.03[3]. Unlike covenants, conditions precedent must

Making a commitment without these conditions leaves the lender "virtually defenseless if a court determines that sufficient terms were agreed upon to make the commitment enforceable."[93] It is usually not practical to try to list all of these conditions during a meeting or a telephone conversation. Even if it were, the odds favor a later misunderstanding regarding what the agreed conditions really were.

It has been noted that "[t]here is an obvious tension between the daily practices of the commercial loan officers who are trained to book new loans (and valued for their ability to do so) and lenders' counsel who want to do everything possible to avoid litigation involving a claim that the lender reneged on an oral commitment."[94] Whether the borrower knew the loan officer had the authority to make a loan being requested can have a significant impact in lender liability litigation. For example, in *National Farmers Organization*,[95] the court enforced a commitment exceeding the bank's legal loan limit because the borrowers were unaware the loan officer did not have authority to make the loan.[96] When the borrower knows the officer lacks authority to make the loan, lenders usually prevail. For instance, in *Kruse*,[97] the court overturned a multimillion dollar verdict for a borrower because, among other reasons, the borrower was aware that the financing for an apple processing plant had to be approved by other bank officers.[98] Lenders unwilling to run the risk of oral commitments should consider delivering a letter or other appropriate notice to every prospective customer, outlining the

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ordinarily be strictly complied with in order to give rise to the other party's duty of performance. *Id.* § 3.03[4]; B. CAPPELLO & F. KOMORASKE, *supra* note 3, § 9.4 ("A lender is entitled to require strict compliance with the conditions precedent to the loan commitment . . . ."). *But cf.* Consolidated Am. Life Ins. Co. v. Covington, 297 So. 2d 894 (Miss. 1974) (compliance with conditions precedent is jury question). For a discussion of the conditions precedent commonly included in loan agreements, see *infra* notes 254-59 and accompanying text.

[93] 2 LENDER LIABILITY L. REP. 8 (Aug. 1988).

[94] *Id.*

[95] National Farmers Org. v. Kinsley, 731 F.2d 1464 (10th Cir. 1984) (discussed *supra* notes 46-49 and accompanying text).

[96] *Id.* at 1469.

[97] Kruse v. Bank of Am., 202 Cal. App. 3d 38, 248 Cal. Rptr. 217 (1988)(discussed *supra* notes 38-45 and accompanying text).

[98] *Id.* at 226-30, 235.

lender's commercial loan approval procedures and the limits of loan officers' authority to lend funds in excess of certain amounts without the approval of appropriate committees.[99]

When only a short time is required to prepare loan documents, commitment letters are usually unnecessary. The parties should wait until the loan documents are executed before entering into a contract.

When a commitment is issued it should "contain all of the material terms and conditions relating to the proposed loan."[100] If the commitment is incomplete, and the lender attempts to condition the loan on the borrower's acceptance of new terms, such as a prepayment penalty or an attorney's fees provision for default, the lender may be held liable for breach of the commitment.

Lenders customarily try to preserve their flexibility by conditioning the loan closing on "the execution of final loan documents satisfactory in form and substance to lender and its counsel."[101] At least one court has held that this kind of provision imposes a duty of good faith and fair dealing on the lender in drafting the loan documents.[102] Good faith and fair dealing are vague terms. What may seem reasonable and fair to a lender may not seem reasonable or fair to an unsophisticated jury examining a lender's motives and conduct several years later.[103]

The best way to ensure that the lender is not second-guessed for refusing to close a loan is to make the commitment letter as complete as possible.[104] The closer the loan documents

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[99] 2 LENDER LIABILITY L. REP. 8 (Aug. 1988).

[100] Hilson, *Drafting Loan Documents in Order to Avoid Lender Liability Claims*, LENDER LIABILITY LITIGATION 1988, at 768 (Practicing Law Institute).

[101] Poscover, *Avoidance Techniques*, IV ABA EMERGING THEORIES OF LENDER LIABILITY 101, 135 (H. Chaitman ed. 1987).

[102] Teachers Ins. & Annuity Ass'n v. Tribune Co., 670 F. Supp. 491 (S.D.N.Y. 1987).

[103] Poscover, *supra* note 101, at 134-35 (quoting Clark, 2 SECURED LENDING ALERT (June 1986)).

[104] Ideally, the commitment letter should include:

(1) *The names of the parties to the commitment* — Frequently, the borrower will be a "to be formed" entity. If that is the case, the commitment needs to specify the names of the individuals to be involved in the organization and any pertinent considerations pertaining to its capitalization.

(2) *The statement of commitment and its expiration date* — If no expiration date for the commitment is set, the courts may require the lender to give reasonable notice

conform to the terms of the commitment, the less likely a court will second guess a lender's decisions.

B. Loan Application

Lenders, like most other businesses, are free to choose

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before terminating the commitment. What is reasonable under the circumstances will be an issue for the jury to decide. Accordingly, it is better for the lender to specify an expiration date, rather than risk having a jury second-guess its determination of reasonableness.

(3) *An overview/description of the contemplated project* — The commitment should state the loan's purpose and what the loaned funds may be used for. If a building project is being financed, the commitment should describe the project in appropriate detail.

(4) *The type of loan and the terms of the note* — The commitment letter should identify what type of loan and financing is contemplated and the terms and provisions of any contemplated note. Matters which should be covered include interest rate, prepayment penalties, term of the note, conditions for advances, and repayment terms.

(5) *The security required* — The commitment should provide a complete description of any collateral being provided for the transaction. If the lender's commitment is conditioned upon its having a first lien position with respect to the collateral, the commitment should say so. Appraisal requirements should also be included. Ideally, the commitment should spell out who will do the appraisal, and what method of valuation will be utilized by the appraiser.

(6) *Guaranties* — Any person from whom a guaranty is required should be identified. Any waiver of rights expected to be included in the guarantees should be specified.

(7) *Commitment fees* — Any commitment fees the lender intends to charge should be specified.

(8) *Environmental matters* — The commitment should grant the lender the right to demand inspection or even an environmental audit of the property if it deems it necessary. Further, the commitment should grant the lender the right to withdraw the commitment or demand pre-closing cleanup of any identified hazardous substances at the borrower's expense prior to funding of the loan by the lender.

(9) *Participation* — If the lender intends to sell participations or if the loan commitment is dependent upon the sale of participations, this should be clearly stated in the loan commitment. Ordinarily, a participant in a loan will insist upon making its own review of the borrower's creditworthiness and make its own evaluation of the merits of the contemplated project. The commitment should authorize the lead lender to permit the participants access to this information.

(10) *Covenants and conditions* — These should be outlined in as great detail as possible. Lenders frequently formulate standard terms and conditions for certain kinds of loans such as construction loans and permanent and real estate financing loans. Provided that they are kept up to date, these terms and provisions can and should be attached to the loan commitment.

For similar descriptions of what should be included in a commitment, see Poscover, *supra* note 101, at 134-39; J. Norton & W. Baggett, *supra* note 3, § 3.03[3].

whom they do business with.[105] Consequently, a lender should incur no liability merely because it rejects a requested loan.[106] Absent a binding loan commitment, a lender has no obligation to lend.

The absence of a loan commitment has not deterred some courts from imposing liability upon lenders for negligent or intentional misconduct in processing loan applications.[107] In *Jacques v. First National Bank*,[108] a lender was held liable for failing to use reasonable care in processing a residential mortgage loan application. Bank customers (the Jacques) contracted to purchase a home. The contract was conditioned upon the Jacques' ability to obtain financing at an annual rate of 12 ¼ % or less. The contract also required the Jacques to increase their downpayment, if necessary, to secure financing at that rate.[109]

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[105] *See* McCarter v. Chamber of Commerce, 126 Md. 131, 94 A. 541, 542-43 (1915) (lender may refuse to do business for any reason). Recognized exceptions to this proposition arise from laws and legal doctrines regulating utilities, common carriers, civil rights, anticompetitive conduct and interference with business relations. *See, e.g.*, Silbert v. Ramsey, 301 Md. 96, 482 A.2d 147, 149 (1984)(without reason or excuse, racetrack owner may exclude any person as long as it does not violate individual's civil rights); *see also* RESTATEMENT (SECOND) OF TORTS § 762(a)-(c)(1965)(discussing lack of duty).

[106] *See* Deere v. Short, 378 S.W.2d 496, 502-03 (Mo. 1964) (manufacturer's refusal to loan dealer money); Faralee Treadwell Co. v. Union & Planters Bank, 135 Tenn. 208, 186 S.W. 92, 93 (1916) (no duty to do business with bank customer).

A closely related proposition is that, absent an extraordinary involvement in a borrower's affairs, a lender should not be held liable for negligently lending money. *See* Wagner v. Benson, 101 Cal. App. 3d 27, 161 Cal. Rptr. 516, 521 (1980) (no liability for negligent lending); Gries v. First Wis. State Bank, 82 Wis. 2d 774, 264 N.W.2d 254, 257 (1978)(court ruled that bank was not negligent in extending credit to borrowers even though two other banks had previously denied borrowers' identical request for money). *But see* Connor v. Great W. Sav. & Loan, 69 Cal. 2d 850, 447 P.2d 609, 619, 73 Cal. Rptr. 369 (1969)(lenders participating in development of subdivision liable to borrowers for defective housing).

[107] The loan application is the first step in the process leading to the making of a binding loan committment:

> The loan application is the first step in the loan documentation process. Historically, a loan application was viewed as an offer to borrow money and the loan commitment as an acceptance of that offer. In current practice the application has diminished in importance and is often considered, even though in the form of an offer, as a mere sale presentation by the potential borrower. In this sense, the loan application is merely a preliminary source of data to be used by the lender in assessing the viability of the loan.

J. NORTON & W. BAGGETT, *supra* note 3, § 3.03[1].

[108] 307 Md. 527, 515 A.2d 756 (1986).

[109] *Jacques*, 515 A.2d at 757.

The Jacques submitted a loan application and paid a loan processing fee to First National Bank of Maryland (First National). First National made no commitment to lend, but agreed to lock in the interest rate desired by the Jacques for a ninety-day period.[110] After processing the Jacques' application, First National concluded that the Jacques qualified for a mortgage loan. However, due to a processing error,[111] the loan amount approved was substantially less than the amount the Jacques wanted financed.[112]

The court held First National liable to the Jacques for the damage caused by its negligence. The court reasoned that First National's promise to process the Jacques' loan application and to lock in an interest rate in consideration for the processing fee paid by the Jacques created a contract between the parties.[113] By promising to process the loan, First National implicitly agreed to do so with reasonable care and was liable for its processing errors.[114]

In *High v. McLean Financial Corp.*,[115] the borrowers alleged that McLean Financial Corporation (McLean) had assured them their mortgage loan would be approved.[116] Later they received a notice from another mortgage company which informed them that their application had been denied.[117] Following *Jacques*, the court held McLean had a duty to use reasonable care

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[110] *Id.*

[111] The jury found the bank had committed negligence by (1) averaging only two years of the Jacques' income, rather than the three years commonly used, when First National knew using two years would distort its evaluation of the Jacques' financial position; (2) omitting stock income from the Jacques' income; (3) including the Jacques' payments on their present residence in calculation of the Jacques' expenses; and (4) placing excessive weight on the debt-to-income ratio. *Id.* at 765 n.7.

[112] *Id.* at 757. The Jacques sought financing of $112,000, but the bank refused to lend more than $41,400. *Id.*

[113] *Id.* at 761-62.

[114] *Id.* at 762. The court also held that First National owed the Jacques a duty of care under principles of tort law because (1) under the circumstances, the Jacques were especially dependent on First National's exercise of due care; (2) First National was aware of the Jacques' dependence; and (3) like insurance, banking is a business affecting the public interest. *Id.* at 762-63.

[115] 659 F. Supp. 1561 (D.C. 1987).

[116] *McLean Fin. Corp.*, 659 F. Supp. at 1566-67.

[117] *Id.* at 1563.

in processing the borrowers' loan application.[118]

Prospective borrowers have also recovered from lenders for misrepresentations made during the processing of a loan application. In *Crystal Springs Trout Co. v. First State Bank*,[119] the loan applicant sought long term financing from the Farmers Home Administration (FmHA) for an expanded fish hatchery. To secure the financing, the applicant, Crystal Springs Trout Co. (Crystal), needed interim construction and working capital financing. First State Bank (FSB) agreed to provide the interim financing and to process the FmHA loan application.[120] Crystal knew the requested interim financing exceeded FSB's lending limit, but FSB repeatedly assured the applicant it would have no problem in securing other lenders' participation in the loan. FSB continued to give these assurances even though it had taken no steps to seek other participants in the loan.[121] FSB also assured Crystal its FmHA application had been submitted when in fact it had not.[122] The court held that these misrepresentations were actionable and affirmed a jury verdict for Crystal.[123]

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[118] *Id.* at 1570. The court stated:

> The complaint alleges that defendant extended assurances that there were "no problems" with plaintiff's application; this alleged statement implies that defendant actually examined whether problems existed. The Court believes that defendant incurred an obligation to process the application with reasonable care when it accepted the application, but it also finds that the defendant's alleged acknowledgement of the application, and alleged attention to the application, show that defendant understood itself to have a duty to plaintiffs.

Id. As in *Jacques*, the applicants paid McLean a loan processing fee and McLean had locked in an interest rate. *Id.*

It is noteworthy that the court also refused to dismiss the borrower's claim of breach of fiduciary duty. The court concluded that a fiduciary relationship might arise if the evidence disclosed that McLean was under an express or implied obligation to treat information supplied by applicants as confidential or if McLean acted not only as a lender, but also "became a broker for or an agent of plaintiffs and thereby acquired a fiduciary duty to them." *Id.* at 1568. The court observed that an agent owes fiduciary obligations to its principal. *Id.* The court carefully noted, however, that if the evidence established the parties dealt at arm's length and that McLean was an independent contractor, instead of an agent, then no fiduciary relationship or liability could exist. *Id.*

[119] 732 P.2d 819, *aff'd in part, rev'd in part on reh'g*, 736 P.2d 95 (Mont. 1987).

[120] *Crystal Springs Trout Co.*, 732 P.2d at 822.

[121] *Id.* at 822-23.

[122] *Id.* at 822.

[123] *Id.* at 827-28.

In *Hamilton v. Caudle*,[124] a bank agreed to assist the Caudles in obtaining a FmHA home mortgage. The bank represented to the customer and the contractor building the customer's home that the FmHA had approved the loan. After the house was built, the Caudles learned that their loan had been denied.[125] The court concluded that the bank owed the Caudles a duty to use reasonable care and that the Caudles could recover for the bank's negligence.[126]

Drawing practical lessons from the cases described above is difficult. The concept of lender liability for negligence in processing loan applications is too new and too unsettled to permit comfortable generalizations about lenders' rights and duties. The concept clashes with the principle that lenders are free to turn down any loan application, even if the applicant appears to meet its criteria for loan approval.[127] *Jacques* and *McLean Financial Corp.* resolved this conflict in favor of liability.[128] Other courts might disagree.

Until the issue is settled, lenders should consider including in their loan applications a more specific description of how the loan will be processed, a disclaimer of any obligation to make a loan as a result of the processing of the application, and an exculpatory clause limiting the applicant's remedy. In addition, lenders should establish internal procedures and training programs to minimize the likelihood the borrower will be provided inaccurate information about its financing prospects. When a lender contemplates that lenders from a secondary market will

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[124] 425 So. 2d 1050 (Ala. 1983).

[125] *Hamilton*, 425 So. 2d at 1051.

[126] *Id.* at 1052. A claim for misrepresentation survived the lender's motion to dismiss in High v. McLean Fin. Corp., 659 F. Supp. 1561 (D.C. 1987), discussed *supra* at notes 115 through 118 and accompanying text. The court held that McLean's statements that there was "no problem," *id.* at 1567, with plaintiffs' loan and that plaintiffs met McLean's lending criteria were fraudulent "if they were *designed to induce plaintiffs* to take actions they would have refrained from if they had been aware of the actual facts." *Id.* at 1567 (emphasis added).

[127] Because of this conflict, an intermediate Maryland appellate court had reversed the jury's finding in *Jacques*, but the verdict was reinstated by Maryland's highest court. Jacques v. First Nat'l Bank, 62 Md. App. 54, 488 A.2d 210 (1985), *rev'd*, 307 Md. 527, 515 A.2d 756 (1986).

[128] For the suggestion that the *Jacques* holding should be limited to consumer loans only, see Ellis & Gray, *supra*, note 3, at 387.

be involved in the loan decision, this fact should be disclosed to the applicant and the applicant's permission secured for the disclosure of the information contained in the application to third parties.[129]

II. Special Loan-Related Documents/Problems

A. Line of Credit

Under traditional definitions, line of credit and loan commitment are distinguishable terms. If definite enough to be enforced, a loan commitment is a binding contract to lend a specified amount of money during a specified period of time and cannot be cancelled except on the grounds stated in the commitment.[130] Unless otherwise expressly provided in the loan agreement, the traditional view is that a line of credit is a credit ceiling that can be cancelled by either party at any time for any reason. The borrower is not required to draw on the line, and the lender may refuse to make advances under the line. Contract rights exist only as to the funds actually advanced by the lender to the borrower.[131]

This view may be changing. In a recent Missouri decision, *Shaughnessy v. Mark Twain State Bank*,[132] the court found that, absent default, a line of credit was a commitment to lend the full amount of the authorized credit because a commitment fee had been paid and the parties had agreed on a definite expiration date for the line of credit.[133] In *Carrico v. Delp*,[134] the

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[129] A. Bloom, *supra* note 3, § 3.03[1]; *Lender May Be Liable for Negligence in Processing Mortgage Application*, 1 Lender Liability L. Rep. 5, 6 (Sept. 1987).

[130] *See supra* notes 13-62 and accompanying text (discussing enforceability of loan commitments).

[131] *See* Midlantic Nat'l Bank v. Commonwealth Gen. Ltd., 386 So. 2d 31 (Fla. Dist. Ct. App. 1980)(discussing rights and obligations under line of credit). As one commentator observed:

> A line of credit is a transaction of convenience. The lender approves the borrower for a certain number of dollars in credit, and gives him an account or line, upon which he can draw. The borrower then takes advantage of an expedited process of getting a loan, submitting a request for an advance on the line rather than a new loan application.

Comment, *Good Faith Theories of Lender Liability*, 48 La. L. Rev. 1181, 1186 (1988).

[132] 715 S.W.2d 944 (Mo. Ct. App. 1986).

[133] *Shaughnessy*, 715 S.W.2d at 954.

court held that a lender's right to terminate a line of credit which contained no termination date, but simply provided that advances would be made "at bank discretion,"[135] was subject to a good faith standard of reasonableness to be determined by the jury.[136] The court held that the parties' agreement was a binding contract because the borrowers had collateralized the line of credit with a second mortgage on real estate and a pledge of the cash value of a life insurance policy.[137] In *Yankton Production Credit Association v. Larson*,[138] the loan documents provided that advances under a line of credit would be made "at the option of the [lender, that] nothing . . . should be construed to obligate the [lender] to make loans or advances, [and that making advances was] in the absolute discretion [of the lender]."[139] The Larsons claimed that the lender's refusal to make advances necessary to complete the expansion of their farm operations violated the implied covenant of good faith and fair dealing.[140] The trial court entered summary judgment for the lender, but the appellate court reversed because the record did not disclose whether the lender's refusal to make further advances "was based on a reasonable, good faith business judgment."[141]

Other courts recognize the traditional distinctions between a line of credit and a commitment. For instance, in *Midlantic National Bank v. Commonwealth General*,[142] the court held that a line of credit "does not impart upon the bank the legal responsibility to loan up to the limit or a responsibility of the lender to borrow up to the limit, but merely facilitates the easier extension of credit."[143] However, no commitment fee had been paid and no line-of-credit agreement had been signed.[144] In *Lawrence*

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[134] 141 Ill. App. 3d 684, 490 N.E.2d 972 (1986).
[135] *Carrico*, 490 N.E.2d at 976.
[136] *Id.*
[137] *Id.* at 975.
[138] 219 Neb. 610, 365 N.W.2d 430 (1985).
[139] *Yankton Prod. Credit Assoc.*, 365 N.W.2d at 432.
[140] *Id.* at 434.
[141] *Id.*
[142] 386 So. 2d 31 (1980).
[143] *Midlantic Nat'l Bank*, 386 So. 2d at 33.
[144] *Id.*

v. Farm Credit System Capital Corp.,[145] a mortgage stated it secured loans of $950,000 "and such further amount not exceeding $1,045,000 *which may be advanced* in the future by the mortgagee."[146] The court held this language left the matter of additional advances wholly up to the lender and refused to imply any obligation to lend up to the limit stated in the mortgage.[147]

Lines of credit often do not have specific termination dates. Nevertheless, some courts have held that lenders have an obligation to give reasonable notice before terminating a line-of-credit arrangement. The leading case is *K.M.C. Co. v. Irving Trust Co.*,[148] a federal appellate decision upholding a $7.5 million jury verdict against a lender for destruction of its borrower's business.[149] The parties' financing agreement provided that Irving Trust could loan, in its discretion, up to an agreed credit line and up to a certain maximum percentage of K.M.C.'s accounts receivable and inventory.[150] Repayment was due on demand.[151] Over a three-year period, the parties developed a course of dealing in which Irving Trust would advance funds under the line of credit to cover K.M.C.'s outstanding checks. K.M.C. began to experience financial problems and requested a $500,000 increase in its credit line. One week later, K.M.C. asked Irving Trust to advance the balance of its credit line to cover overdrafts. Although fully secured, Irving Trust refused to make the requested advances. K.M.C.'s checks were dishonored, and despite later advances by Irving Trust, K.M.C.'s business was destroyed.[152] The court held that the implied covenant of good faith and fair dealing obligated Irving Trust to give K.M.C. notice and an opportunity to secure alternative financing before refusing further advances, absent a "valid business reason precluding Irving Trust from advancing the required funds without prior no-

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[145] 761 P.2d 640 (Wyo. 1988).

[146] *Lawrence*, 761 P.2d at 645.

[147] *Id.* at 646.

[148] 757 F.2d 752 (6th Cir. 1985).

[149] *K.M.C. Co.*, 757 F.2d at 766.

[150] *Id.* at 754.

[151] *Id.* at 760.

[152] *Id.* at 754, 762.

tice."[153] Since Irving Trust was fully secured, the court concluded that K.M.C.'s financial difficulties were insufficient justification for refusing further advances without notice.[154]

Failure to give adequate notice was one of the grounds leading to a multimillion dollar judgment against a lender in *Ricci v. Key Bancshares of Maine, Inc.*[155] The lender extended a $1 million line of credit to a physician and Ricci, a young Italian-American. The line-of-credit agreement required the borrowers to submit a loan application for each draw and gave the lender the right, in its sole discretion, to approve or disapprove each application. The borrowers were successful and performed their obligations under the agreement. However, an investigator advised the lender that an FBI agent had stated that Ricci was connected to organized crime. Acting on this information, the bank terminated the line of credit, citing as its reason for doing so a shift in management and lending philosophies. Later, the bank offered as an additional excuse the fact that the lender had reached its legal lending limit. The jury found that the bank had acted in bad faith by failing to state the real reason for terminating the line of credit and for terminating the line of credit without adequate notice.[156]

The cited authorities establish that in most cases a lender's interests are best served when a complete and comprehensive line-of-credit agreement is executed, setting forth conditions and covenants which protect the lender's rights. If no termination date for the line of credit is provided, the agreement should stipulate that it is subject to cancellation on *X* days' written

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[153] *Id.* at 763.

[154] *Id.*

[155] 662 F. Supp. 1132 (D. Me. 1987).

[156] Some facts not reported in the published opinion are reported in Poscover, *Avoidance Techniques — Relying on Secondhand Information*, 1 LENDER LIABILITY L. REP. 2-4 (July 1987). *K.M.C.* and *Ricci* involved breach of the covenant of good faith and fair dealing. A notice requirement may also arise through course of dealings. For instance, in Alaska State Bank v. Fairco, 674 P.2d 288 (Alaska 1983), the security agreement provided that if the debtor missed a payment the lender could accelerate the note and take possession of the collateral securing the note without notice. *Id.* at 289. After the borrowers missed two payments, the parties entered into workout negotiations. *Id.* at 290. During the course of those negotiations, the lender took possession of the collateral without giving notice to the borrower. *Id.* The court held that the negotiations had effectively modified the security agreement and upheld a verdict for the borrower. *Id.* at 292.

notice.[157]

Expressly setting up the line of credit as a loan commitment may benefit the lender if a priority dispute later arises. The Mississippi Uniform Commercial Code provides that a person who becomes a lien creditor after a security interest is perfected is subject to the earlier security interest only to the extent that it secures advances made before the person became a lien creditor or within forty-five days thereafter or without knowledge of the lien or pursuant to a commitment entered into without knowledge of the lien; an advance is made pursuant to commitment if the secured party is legally bound to make it, even if a subsequent event of default under the commitment relieves him of his obligation.[158] These provisions may protect lenders making advancements under a commitment when a federal tax lien or a judgment lien is filed against the borrower's assets. If the advance is made pursuant to a totally *discretionary* line of credit after a judgment lien or a tax lien attaches, the tax/judgment lienor may attempt to argue it has priority over the lender with respect to these funds. If a commitment is not desired, the guidelines offered in the next subsection dealing with demand notes should be followed.

B. Demand Notes

By definition, a demand note is an instrument payable on sight or demand, without further notice.[159] In *K.M.C.*, the moneys advanced to the borrowers under the line of credit were payable on demand. Irving Trust argued that since it could demand repayment without notice, it had no obligation to give the borrower any notice before it refused further advances under the parties' line of credit.[160] The court rejected this argument, holding that section 1-208 of the U.C.C.,[161] which applies to provi-

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[157] Hilson, *supra* note 100, at 769.

[158] MISS. CODE ANN. § 75-9-301(4) (Supp. 1982); *id.* § 75-9-105(1)(k) (1972).

[159] MISS. CODE ANN. § 75-3-108 (1972). The statute reads, "Instruments payable on demand include those payable at sight or on presentation and those in which no time for payment is stated." *Id.*

[160] *K.M.C. Co.*, 757 F.2d at 759.

[161] MISS. CODE ANN. § 75-1-208 (1972) states:

A term providing that one party or his successor in interest may accelerate

sions permitting a lender to accelerate a loan at will or when the lender deems itself "insecure,"[162] precluded enforcement of the loan agreement's demand provision unless Irving Trust concluded in good faith that its prospects for payment were impaired.[163] Since Irving Trust was fully secured, the court concluded that Irving Trust had no reason to refuse to make further advances without notice and that Irving Trust had acted in bad faith.[164]

K.M.C. is the only decision holding there is a good faith limitation on a lender's right to call a true demand instrument.[165] As one court noted, the borrower signing a demand note "did not agree that payment would be made only when demand was made in good faith but agreed that payment would be made whenever demand was made."[166]

Lenders should be aware, however, that some courts narrowly construe the kinds of notes which will be considered true demand notes. The U.C.C. defines demand instruments to "*include* those payable at sight or on presentation and those in

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payment or performance or require collateral or additional collateral "at will" or "when he deems himself insecure" or in words of similar import shall be construed to mean that he shall have the power to do so only if he in good faith believes that the prospect of payment or performance is impaired. The burden of establishing lack of good faith is on the party against whom the power has been exercised.

Id.

[162] *Id.*

[163] *K.M.C. Co.*, 757 F.2d at 760.

[164] *Id.* at 761.

[165] Centerre Bank v. Distributors, Inc., 705 S.W.2d 42, 48 (Mo. Ct. App. 1985). For contrary holdings, see Taggart & Taggart Seed, Inc. v. First Tenn. Bank, 684 F. Supp. 230, 235 (E.D. Ark. 1988) (U.C.C. good faith requirement not applicable to demand note); Spencer Cos., Inc. v. Chase Manhattan Bank, 81 Bankr. Rep. (West) 194, 199 (D. Mass. 1987) ("The holder of a demand note does not need a good faith reason or any reason at all to demand payment."); Pavco Indus., Inc. v. First Nat'l Bank, 534 So. 2d 572, 577 (Ala. 1988) (comments to U.C.C. § 1-208 to effect that this section has no application to demand notes supersedes any good faith duty of U.C.C. § 1-203; U.C.C. does not impose any good faith requirement on right to demand payment of demand note); Flagship Nat'l Bank v. Gray Distrib. Sys., Inc., 485 So. 2d 1336, 1340 (Fla. Dist. Ct. App. 1986) (U.C.C. §§ 1-203 and 1-208 not applicable to demand notes because express contractual provisions permit calling of loan obligation at any time). However, the court in *In re* Martin Specialty Vehicles, Inc., 87 Bankr. Rep. (West) 752 (D. Mass. 1988) suggested in dicta that demand notes are subject to a good faith limitation. *Id.* at 765.

[166] *Centerre Bank*, 705 S.W.2d at 48.

which no time for payment is stated."[167] When the loan documents contain provisions suggesting that the requirement of payment is contingent upon events other than demand, such as a provision providing for acceleration upon certain events of default, some courts have held that the note is not a true demand instrument and that the good faith limitations contained in section 1-208 of the U.C.C. on the acceleration of loans at will is applicable.[168] For instance, in *Reid v. Key Bank*,[169] the court held that section 1-208 applied to termination of a $25,000 line of credit evidenced by a $25,000 demand note because (1) the entire $25,000 had not been drawn, and the face amount of the note could therefore not be due on demand; (2) the security agreement provided for acceleration upon the occurrence of events of default; (3) the note contained provisions governing the acceleration of payment or termination which would render the note payable on demand; and (4) a bank officer admitted that the line of credit could not be terminated precipitously.[170]

A middle course was adopted by a bankruptcy court in *Spencer Co. v. Chase Manhattan Bank*.[171] The court observed that a pure demand note, meeting all the requirements of the U.C.C. is immediately payable upon execution without the necessity of a formal demand for payment.[172] However, when the terms of the demand note evidence that the debt is not due until a later date (such as a provision providing for the payment of interest at one rate until maturity and then at a different rate thereafter), the note is not due until a formal demand for payment is made.[173] Significantly, the court emphatically rejected

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[167] U.C.C. § 3-108 (1988).

[168] *See, e.g., Martin*, 87 Bankr. at 765 (demand instruments do not defeat the obligation of good faith).

[169] 821 F.2d 9 (1st Cir. 1987).

[170] *Reid*, 821 F.2d at 13-14.

[171] 81 Bankr. Rep. (West) 194 (D. Mass. 1987).

[172] *Spencer Cos.*, 81 Bankr. Rep. (West) at 198.

[173] *Id.* In *Spencer Cos.*, the note in question provided for one rate of interest from the date of execution until the date the principal amount became due, and a higher rate of interest for any amount of principal not paid on that date. *Id.* The court reasoned that these provisions contemplated that the debt would mature at some point *after* the execution of the note. *Id.* Since demand notes are immediately due *at the time of* execution, the court concluded that the note was not a true demand note. *Id.* A recent article characterized this type of note as a "demandable note." West & Haggerty, *supra* note 3, at

the borrower's argument that the bank's right to make this formal demand was subject to the obligation of good faith and fair dealing.[174]

If a demand instrument is a true demand note under the U.C.C., the lender should be able to demand payment under the note and to foreclose on its security if the demand is not honored without concern over the duty of good faith and fair dealing. To insure that no question arises later about whether a demand was or was not made, the lender should make the demand in writing and either have the demand delivered by hand to the borrower (not dropped off at his place of business or house), or by certified mail. If it is feasible to do so, it is good practice to give the borrower a reasonable time period in which to pay the note prior to enforcing the lender's rights against its collateral; but notice is not a legal requirement.

Special care should be taken in drafting demand notes. Standard form notes, loan agreements, security agreements and deeds of trust usually contain language inconsistent with the demand feature. Different forms should be used. In a recent federal district court case, *Taggart & Taggart Seed, Inc. v. First Tennessee Bank National Association*,[175] the line-of-credit agreement between the lender and the borrower contained the following provision:

> Nothing contained herein, in the Security Agreements, or in any other loan documents shall be construed to prevent Bank from making demand for payment of the Loan and all other extensions of credit at any time that Bank, in the exercise of its sole discretion, deems necessary or desirable; and, in the event of such demand, (a) Bank shall have no further obligation to make loan advances or to extend credit, and (b) the entire unpaid principal balance of the Loan and other extensions of credit, and all accrued interest, shall become due and payable for all purposes immediately upon the making of such demand.[176]

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[174] *Spencer Cos.*, 81 Bankr. Rep. (West) at 199.

[175] 684 F. Supp. 230 (E.D. Ark. 1988).

[176] *Taggart & Taggart Seed, Inc.*, 684 F. Supp. at 235.

The loan agreement also provided that "[u]pon the occurrence of any Event of Default, as specified herein, *or upon Bank's demand for payment of the note, the Bank shall, at its option, be relieved of any obligation to make further extensions of credit* under this Agreement."[177] The court held that these provisions established that the bank had a right to terminate the loan relationship at any time, for any reason, and that there was no good faith limitation on the lender's right to demand repayment.[178]

Before making demand the lender should carefully explore the possibility that the lender's right to make demand without notice has been modified or waived by the course of dealing[179] between the parties or by oral assurances or promises made by a loan officer.

C. Leveraged Buyouts

A leveraged buyout (LBO) occurs when the buyer of a target company utilizes the assets and cash flow of the target company to secure the financing for the acquisition. Often the target's present or past management participates in the buyout. LBO's usually are structured as stock purchases to avoid the tax implications of an asset sale; they can, however, be structured as an asset acquisition, merger or some combination thereof.[180]

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[177] *Id.* at 235 n.3.

[178] *Id.* at 236.

[179] *See infra* note 366 and accompanying text (course of dealing amounting to waiver).

[180] Murdock, Sartin & Zadek, *Leveraged Buyouts and Fraudulent Transfers: Life After Gleneagles*, 43 BUS. LAW. 1 (1987); Sabin, Goodman & Neporent, *Lender Liability in Connection With Leveraged Acquisitions*, LENDER LIABILITY LITIGATION 1988 865 (Practicing Law Institute 1988). Authors Murdock, Sartin & Zadek provide an excellent description of varying forms of acquisitions, as follows:

> In a typical stock acquisition LBO, a holding company (Holding Company) is formed by the acquiring parties in order to enter into a stock purchase agreement with the existing shareholders (Sellers) of the target company (Target). The lender (Lender) makes an unsecured loan to the Holding Company, the proceeds of which are used to purchase the stock of Target. A second loan is then made to Target secured by liens on its assets. The proceeds of the second loan are upstreamed to Holding Company, which in turn repays the unsecured first loan to Lender.
>
> A variation of this stock acquisition occurs when Holding Company is

Since LBO's usually involve the sale of stock, lenders are exposed to potential liability under state and federal securities laws.[181] Because the lenders financing LBO's frequently participate in structuring the transactions and may insist upon greater involvement in the management of the debtor, they may have greater exposure under common law theories of lender liability.[182]

Lenders financing LBO's also face increased exposure under laws prohibiting fraudulent transfers since LBO's may disadvantage the target's unsecured creditors. After an LBO the target's assets secure a much larger debt. The old shareholders, who normally would be paid last, are cashed out ahead of unsecured creditors "leaving the target company highly leveraged."[183] Not surprisingly, if the target fails after an LBO, unsecured credi-

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merged downstream into Target following the initial unsecured loan to the Holding Company and its purchase of the stock of Target. Following the merger, Target then grants to the Lender liens and security interests in Target's assets. Another variation contemplates that the Holding Company purchases the stock of Target in exchange for a demand note issued by the Holding Company in favor of the Seller, which results in Target's becoming a wholly owned subsidiary of the Holding Company. Lender then makes a secured loan to Target, which dividends or otherwise transfers the loan proceeds to the Holding Company; the Holding Company then uses the proceeds to pay the demand note. This third approach is preferable from Lender's standpoint since Target, and not Holding Company, is the initial borrower who receives the loan proceeds.

In a typical asset acquisition, by comparison, a new corporation (Newco) is formed to purchase the assets, and perhaps assume the liabilities, of Target. Lenders make a loan to Newco, secured by the assets purchased by Newco from Target. The loan proceeds are then distributed by Target to its stockholders in connection with a liquidation of Target. A variation of this approach contemplates that old Target does not liquidate and does not distribute the asset sales proceeds to its shareholders. This variation may have the effect of protecting old Target's unsecured creditors if the price paid by Newco for the assets constitutes the "present fair salable value" of the assets or a "reasonably equivalent value" for the assets.

Murdock, Sartin & Zadek, *supra*, at 3-4.

[181] *See* Kirby, *Lender Liability Issues in Leveraged Buyout Financing*, LENDER LIABILITY LITIGATION 1988 919, 931-41 (Practicing Law Institute) (discussion of securities laws).

[182] These theories are discussed in detail in Williamson & Tanner, *supra* note 4, at 1-47. Other possible risks in LBO's not discussed in this article include corporate law restrictions on dividends and other distributions, and tax consequences.

[183] Kirby, *supra* note 181, at 922-23.

tors, a bankruptcy trustee or a Chapter 11 debtor in possession will often charge that the financing arrangement was a fraudulent transfer.

Section 548(a) of the Bankruptcy Code[184] authorizes the bankruptcy trustee or Chapter 11 debtor in possession to avoid a grant of a security interest in the debtor's assets or an obligation incurred by the debtor made or incurred within one year of the order for relief if the debtor made the transfer or incurred the obligation with actual or constructive intent to hinder, delay, or defraud other creditors.[185] Constructive fraud occurs when the debtor receives less than reasonably equivalent value for the transfer, and (1) was insolvent when the transfer was made or the obligation incurred, or became insolvent because of the transfer or obligation, (2) was left with an unreasonably small amount of capital to operate its business, or (3) intended to or believed that it would incur debts beyond its ability to pay in due course.[186] The Bankruptcy Code also permits the trustee or debtor in possession to bring an action to avoid a transfer of a security interest or an obligation which would be deemed a fraudulent conveyance under state law.[187]

Courts have applied the law of fraudulent conveyances to LBO's. The leading case is *United States v. Tabor Court Realty Corp.* (*Gleneagles*),[188] a federal appellate decision based upon the Pennsylvania Uniform Fraudulent Conveyance Act.[189] In that case the target's shareholders sold their stock to a new company. The acquisition was financed in two steps. First, the lender made a loan to the target and certain of its subsidiaries; the loan was secured by mortgages on the target's assets and guaranteed by the target's subsidiaries. The loan proceeds were then loaned by the target to the new holding company; the loan

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[184] 11 U.S.C. § 548(a) (1989).

[185] *Id.*

[186] *Id.* For a discussion of the transfer, insolvency and standing elements of § 548(a), see Sabin, Goodman & Neporent, *supra* note 180, at 873-83.

[187] 11 U.S.C. § 544(b)(1988). For Mississippi statutes concerning fraudulent conveyances, see MISS. CODE ANN. §§ 11-5-75; 15-3-3; 15-3-5 (1972 & Supp. 1989).

[188] 803 F.2d 1288 (3d Cir. 1986), *cert. denied*, 483 U.S. 1005 (1987).

[189] PA. STAT. ANN. tit. 39, §§ 351-63 (1988).

was evidenced by a note but not collateralized.[190]

The court held that the mortgages were fraudulent transfers, under both the actual and constructive fraud tests, because (1) all parties to the transaction knew of the target's weak financial condition and its limited ability to pay its debts at the time of the LBO; (2) all parties knew that the increased debt resulting from the LBO made it more unlikely creditors could be repaid;[191] and (3) the consideration for the transfers was inadequate since the new company had no ability to repay the unsecured loan made by the target.[192] One commentator has suggested that *Gleneagles* creates a presumption that " 'fair value' for a loan is not given to target[s] in leveraged buyout[s] since proceeds are transferred to shareholders and not retained in [the] business."[193]

Similarly, in *In re Metro Communications, Inc.*,[194] a shell corporation borrowed $1.85 million from Mellon Bank and bought the stock of the target corporation with the loan proceeds. The target, as a subsidiary of the shell, guaranteed the shell's debt to the lender and secured the guaranty by pledging the target's assets. The lender also provided the target a $2.3 million working capital line of credit that was drawn upon by the target.[195]

The *Metro Communications* court invalidated the lender's lien as a fraudulent conveyance, holding that the target did not receive reasonably equivalent value for the collateral pledge in either the $1.85 million loan to the shell or the $2.3 million working capital loan to the target.[196]

To protect against fraudulent transfer liability,[197] lenders

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[190] *Tabor Court Realty Corp.*, 803 F.2d at 1292-93, 1302.

[191] *Id.* at 1295-1305.

[192] *Id.* at 1303-04.

[193] Kirby, *supra* note 181, at 928.

[194] 95 Bankr. 921 (W.D. Pa. 1989) .

[195] *Metro Communications*, 95 Bankr. at 924.

[196] *Id.* at 934. While the *Metro Communications* holding as to the $1.85 million stock purchase loan appears consistent with *Gleneagles* and its progeny, the $2.3 million working capital loan to the target would appear to be reasonably equivalent value for a pledge of the target's assets. *Leveraged Buyout Lender Loses Lien*, 2 LENDER LIABILITY L. REP. 1, 1-2 (June, 1989).

[197] Obviously, there is no procedure or structure that will guarantee that an LBO

should require documentation demonstrating that the financing plan will not render the target insolvent, uncapitalized or unable to pay its unsecured creditors. To this end lenders should obtain appraisals and solvency opinions from investment bankers, independent accountants and valuation consultants,[198] corporate officers' certificates confirming the target's financial condition, and forecasts showing the target's ability to service its debt after the LBO is consummated.[199] These financial projections and appraisals should be as accurate and conservative as reasonably possible.[200] A legal opinion from counsel for the borrower and guarantor concerning the enforceability of the debt and security instruments should also be obtained.[201]

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will withstand a fraudulent transfer claim. Lenders must therefore weigh the prospect that a particular structure may give greater protection from fraudulent conveyance liability against other business considerations such as tax or credit benefits. Kirby, McGuinness & Kandel, *Fraudulent Conveyance Concerns in Leveraged Buyout Lending*, 43 BUS. LAW. 27, 40-41 (1987).

[198] *Id.* at 47. "Because each of these professionals has limits on the scope of their expertise or ethical or practical restraints on their ability to report, a lender frequently receives comfort from more than one such expert in a particular transaction." *Id.*

[199] *See generally* Kirby, *supra* note 181, at 928 (lenders should obtain evidence that "financial condition" tests are met); Kirby, McGuinness & Kandel, *supra* note 197 (structural considerations for insulating transactions from fraudulent transactions laws); Murdock, Sartin & Zadek, *supra* note 180, at 20-21 (defenses against subsequent attack on LBO should be established beflore closing); Sabin, Goodman & Neporent, *supra* note 180, at 907 (protect target lien by documenting that LBO did not render target insolvent).

[200] Murdock, Sartin & Zadek, *supra* note 180, at 21. For a discussion of the shortcomings of using generally accepted accounting principles, see Kirby, McGuinness & Kandel, *supra* note 197, at 46-47.

[201] Kirby, McGuinness & Kandel, *supra* note 197, at 48-49. Counsel rendering the opinion may insist upon a specific exception for fraudulent conveyance claims under 11 U.S.C. § 548 and applicable state statutes. Such an exception might weaken the lender's claim of having acted in good faith. Kirby, McGuinness & Kandel, *supra* note 197, at 49. As a compromise, it has been suggested that the following provision be added:

> We have not been requested to render and, with your permission, we express no opinion as to the applicability to the obligations of Target under the Loan Documents of Section 548 of the Bankruptcy Code and Section _____ of the [State] Debtor & Creditor Law relating to fraudulent transfers and obligations. However, we understand, without independent verification, that Lender has satisfied itself on the basis of, among other things, the financial information furnished to Lender and its knowledge of the credit facilities available to Target, that Target is not insolvent and that Target will not be rendered insolvent by the transactions contemplated by the Loan Documents and that, after giving effect to such transactions, Target will not be left with unreasonably

Exposure to fraudulent transfer liability may also be avoided by restructuring the transaction. An asset acquisition ordinarily will not expose the lender to fraudulent transfer liability since the target receives reasonable value for the assets it acquires. However, the acquisition may still be subject to attack under the fraudulent conveyance laws if the proceeds of the loan immediately flow through the target to the old shareholders. Moreover, the target's assets may be subject to claims under state bulk sales laws if those laws are not strictly followed.

Additionally, fraudulent conveyance liability may be avoided by making an acquisition loan secured by a pledge of the target's stock. No fraudulent transfer occurs because the proceeds of the loan were given in return for a pledge of the target's stock. This structure leaves the lender less secure, however, since it has no direct lien on the target's assets.[202]

The suggestions outlined herein are best regarded as supplemental to, and not a substitute for, the lender's own credit analysis. Selection of an LBO candidate whom the lender honestly believes, after careful, prudent analysis, will remain solvent and have sufficient cash flow to pay its obligations is the best defense to a fraudulent conveyance attack.[203]

D. Guaranties and Comfort Letter

On a routine basis, lenders are faced with situations where they are unwilling to lend to a prospective borrower alone but would be willing to lend if a satisfactory third party agreed to be bound by the terms of the loan agreement in the event the borrower breached its obligations. In other situations the lender may be willing to lend to the borrower based on its creditworthi-

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small capital with which to engage in its anticipated business and that Target will not have intended to incur, or will not have believed it has incurred, debts beyond its ability to pay as such debts mature.

Id.

[202] *See* Sabin, Goodman & Neporent, *supra* note 180, at 905-07 (discussion of techniques lender may use to protect against fraudulent transfer liability).

[203] *See LBO's Irresistible to Lenders But Fraught with Legal Risks*, 1 LENDER LIABILITY NEWS 7, 7-8 (Jan. 25, 1989)(lender should document efforts so as to show good faith); Kirby, McGuinness & Kandel, *supra* note 197, at 48 (lender should carefully analyze cash flow of target).

ness alone but still seek to have some assurances as to the stability of the borrower. The first situation calls for a guaranty by the third party; the latter situation is generally satisfied by a comfort letter from a third party.

A lender should not settle for a comfort letter if what the lender really expects is a guaranty. As a rule, the lender wants the most assurances it can get that the loan will be repaid; the third party prefers not to give any such assurances at all. The third party will always opt to provide the lender with a comfort letter. But if the purpose of the letter is to give the lender another source for repayment, the lender must *insist* on a document that meets the criteria for a guaranty.

A comfort letter is not a binding obligation to pay. A comfort letter is intended only to give the lender some additional assurances as to particular aspects of the business. A comfort letter may take many forms: it may be furnished by a parent corporation on behalf of its subsidiary, stating the degree of ownership by the parent corporation and perhaps representing that the parent's ownership interest will not be disposed of as long as the particular loan in question is outstanding or agreeing to give the lender notice prior to disposing of any interest; a controlling shareholder may furnish a similar comfort letter; a key employee may furnish a comfort letter, agreeing to remain in the employment of the company as long as the debt is outstanding; or a debtor of the borrower may provide a comfort letter to the bank that acknowledges the debt, states that there are no defenses to the debt, and outlines the anticipated schedule of repayment.[204] Although there are instances where comfort letters have been construed to constitute guaranties,[205] the lender should proceed on the assumption that it will be unsuccessful in legally converting a comfort letter to a guaranty.

In contrast to the comfort letter, a guaranty *is* a legally binding obligation on the part of the guarantor to repay the debt of the borrower. In drafting a guaranty, the following items

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[204] *See generally* Weissman, *Loan Documentation: Current Issues*, 42 CURRENT LEGAL ISSUES OF FINANCIAL INSTITUTIONS 131, 157-58 (1987) (factors to consider in dealing with guarantees).

[205] *See generally* Sacasas & Wiesner, *Comfort Letters: The Legal and Business Implications*, 104 BANKING L.J. 313 (1987)(comfort letter held to be guaranty).

should be considered:[206]

(1) The guaranty must be in writing to satisfy the statute of frauds, should be executed at the same time as the other loan documents, and should expressly be assignable.

(2) The type of guaranty should be clearly set out, that is, general or specific, absolute or conditional, limited or unlimited, secured or unsecured.

(3) The liability of all guarantors should be joint and several, should cover future advances and should be applicable to "all renewals, amendments, extensions, consolidations and modifications of the underlying indebtedness."[207]

(4) The guaranty should include a clause subordinating all debts owed by the borrower to the guarantor to that owed to the lender.

(5) The guaranty should include a provision that the failure or delay of the lender to exercise a right or remedy is not deemed to be a waiver of such right or remedy.

(6) The guaranty should also allow the lender to take certain action without discharging the guarantor, such as releasing all or part of the collateral, substituting collateral, modifying terms of the loan agreement (including extensions or renewals), and releasing any or all other guarantors without releasing the guarantor in question.

(7) The guaranty should include a covenant on the part of the guarantor to take no action that would materially change its financial status as long as the guaranty is effective, nor to sell, mortgage, or pledge any of the guarantor's property unless the lender consents.[208]

(8) The guaranty should clearly outline how payments are to be treated, that is, it should explain whether payments are applied first to amounts guaranteed or to unguaranteed debt.

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[206] *See generally* W. HILLMAN, COMMERCIAL LOAN DOCUMENTATION 225-66 (1986) (forms and practical considerations); Harrison, *Sureties, Guarantors and Accommodation Parties*, 42 CURRENT LEGAL ISSUES OF FINANCIAL INSTITUTIONS 163 (1987) (results from use of various guaranties); R. NASSBERG, THE LENDER'S HANDBOOK 19-20 (1986)(forms and practical considerations); Weissman, *supra* note 204, at 141-46 (recommendations for well-drafted guaranty).

[207] Weissman, *supra* note 204, at 143.

[208] W. HILLMAN, *supra* note 206, at 240.

Lenders should be aware that guaranties made by corporate entities can create special problems, including issues of fraudulent conveyances.[209] Section 548(a) of the Bankruptcy Code[210] allows a trustee in bankruptcy or a Chapter 11 debtor in possession to avoid certain guaranties. One of the tests for avoidance is whether fair consideration was given. The general rule is that a bankrupt's guaranty is a transfer without fair consideration. However, an exception to the rule arises if the parties are so related that they share an identity of interests.[211] This identity of interests is an especially important concept where a parent corporation guarantees the debt of a subsidiary corporation, or vice versa. If the parent guarantees the subsidiary's debt, there is a strong presumption that the parent receives a benefit by virtue of its ownership interest in the subsidiary; on the other hand, proof of benefit must be shown where a subsidiary guarantees the debt of its parent.[212]

Lenders who take guarantees from insiders of the borrower may also find themselves subject to preference liability under Section 547 of the Bankruptcy Code for payments made to the lender within one year of the borrower's bankruptcy filing, rather than the usual ninety day reach-back period. In *Levit v. Ingersoll Rand Financial Corp.*,[213] a construction firm borrowed money from a number of lenders. The firm's president, Deprizio, co-signed the bank's note. Deprizio and his brothers, all of whom were insiders, also guaranteed the firm's debts to other lenders.[214]

The construction firm subsequently became a Chapter 7 bankruptcy debtor, and the Chapter 7 Trustee filed a preference action against these lenders, utilizing the section 547(b)(4)(B)[215] one-year preference applicable to insiders rather than the sec-

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[209] *See generally* Harrison, *supra* note 206, at 191-97 (fraudulent transfers under § 548(a) of Bankruptcy Code).

[210] *See supra* notes 180-201 and accompanying text (discussing bankruptcy concerns).

[211] Harrison, *supra* note 206, at 193.

[212] *Id.* at 194.

[213] 874 F.2d 1186 (7th Cir. 1989).

[214] *Levit*, 874 F.2d at 1187.

[215] 11 U.S.C. § 547(b)(4)(B)(1988).

tion 547(b)(4)(A)[216] ninety-day preference period applicable to non-insiders. The Trustee argued that the payments to the lenders were preferences because they were for the benefit of insider creditors, that is, the firm insiders who had personally guaranteed or co-signed on the debts. The bankruptcy court rejected this argument, relying on lower court cases holding that the payments are not preferences as to the lenders because the lenders themselves were not insiders.[217] The district court reversed,[218] and the Seventh Circuit, the first Court of Appeals to decide this issue, affirmed the reversal, holding that since the guarantors were insiders and since the payments benefitted the insiders, the expanded one-year preference period applied notwithstanding the fact that the lenders themselves were not insiders.[219]

In spite of *Levit*, lenders should not necessarily forego taking an insider's guaranty in every instance. The *Levit* holding presents lenders with the increased possibility of an unrecouped loss from preference liability when the lender, whose insider-guarantor cannot pay the guaranteed debt, receives a payment between ninety days and one year before the borrower's bankruptcy.[220] Thus, the lender may want to consider not taking a guaranty from an insider when the insider cannot pay the debt if

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[216] 11 U.S.C. § 547(b)(4)(A)(1988).

[217] *Levit*, 874 F.2d at 1188.

[218] *Id.*

[219] *Id.* at 1200-01.

[220] Nutovic, *The Bankruptcy Preference Laws: Interpreting Code Sections 547(c)(2), 550(a)(1), and 546(a)(1)*, 41 BUS. LAW. 175, 176-77 (1985). Even in these circumstances, many ordinary commercial payments may escape preference liability because of the requirements of 11 U.S.C. § 547(b)(5) and the preference exceptions of 11 U.S.C. § 547(c), particularly the ordinary course of business exception of section 547(c)(2). *Levit*, 874 F.2d at 1199. Section 547(b)(5) states that a transfer is not a preference to the extent the creditor did not receive more than it would have if the transfer were not made and the debtor were liquidated in a Chapter 7. *Id.* Section 547(c)(2) states that a transfer may not be avoided as a preference:

> . . . to the extent that such transfer was —
>
> (A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee;
>
> (B) made in the ordinary course of business or financial affairs of the debtor and the transferee; and
>
> (C) made according to ordinary business terms.

11 U.S.C. § 547(c)(2)(1986).

called upon.[221]

In light of the *Levit* ruling, if a guaranty from an insider is to be obtained, the following provisions should be considered in addition to the provisions previously discussed:
(1) a provision clarifying that the guarantor is liable for all payments subsequently avoided and recovered by a bankruptcy trustee or debtor in possession;[222] and
(2) a provision whereby the guarantor waives the rights of reimbursement, contribution and indemnity from the principal debtor and subrogates its rights to the rights of the lender against the principal debtor.[223]

E. Accommodation Letters/Credit Inquiries

Customers frequently ask lenders to perform services for them as a special favor. For example, a customer wants to go to an equipment auction and desires to purchase equipment with his checks. To avoid any problems in persuading the auctioneer to accept the customer's checks, the customer requests its bank to write a letter stating that the checks are good. The bank prepares what is commonly referred to as an accommodation letter, which may say, for example, that the customer has been doing business with the bank for years and that his checks are probably good. Essentially, the customer is asking the bank to perform a service for which the bank is paid no compensation. If a letter of credit were issued, or a line of credit established, or if the checks were certified, the bank would probably charge a fee.

Likewise, third parties frequently contact lenders to inquire as to the credit status of the customer. Typical inquiries include

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[221] Nutovic, *supra*, note 220, at 198.

[222] *Id.* at 197 n.98; Baer, *Seventh Circuit Holds Lender Subject to One-Year Preference Period Because It Held Guarantee*, 3 LENDER LIABILITY L. REP. 1, 3 (July 1989). Such a provision is admittedly of little comfort if the guarantor cannot pay.

[223] The purpose of this provision is to negate the claim that payment to the lender was to or for the benefit of an insider-guarantor "creditor" who has a contingent claim against the estate since the insider-guarantor, upon payment, would normally succeed to the lender's rights against the borrower. *Levit*, 874 F.2d at 1190 ("under § 101(9) . . . any person with a [contingent] 'claim' against Firm is a 'creditor' . . . . A guarantor has a contingent right to payment from the debtor; if Lender collects from Guarantor, Guarantor succeeds to Lender's entitlements and can collect from Firm."); Baer, *supra* note 220, at 3.

such questions as: Is this check good? Does the customer pay on time? How do you rate this customer? Does this customer have any loans outstanding and, if so, are they in good standing?

Regardless of whether the service is an accommodation letter or a credit check by a third party, these uncompensated generosities extended on behalf of the customer could ultimately result in substantial liability to the lender if the lender is not especially careful. The lender intends the accommodation letter or credit response to be merely a good recommendation. However, the third party may construe the action as something much more—such as a guaranty or an agreement that the customer will be granted credit to cover checks in question.

As mentioned previously, with limited exceptions, a guaranty must be in writing to be enforceable.[224] The lender may presume that as long as nothing is in writing his risk of exposure is lessened. However, this is simply not true. As a routine practice even credit responses should be in writing (or, at a minimum, noted by memoranda in the file). A key to avoiding liability in this area of banking practice is *proper wording.* Accommodation letters and credit responses should not be quickly thrown together but should be drafted only after careful and thorough consideration. For the sake of simplicity accommodation letters and credit inquiry responses will hereinafter be discussed in one general discussion on credit references.

1. The Lender's Liability for Credit References

Borrowers and third parties have used many theories in attempting to hold lenders liable for credit references: fraud, negligent misrepresentation, antitrust violations, and violations of securities laws.[225] Antitrust violations may be alleged if a bank uses credit information to make changes in its terms with a customer to parallel that of another bank or if banks agree to take

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[224] MISS. CODE ANN. § 15-3-1 (1972).

[225] The lender should also take into consideration such factors as the customer's right to privacy before giving out credit information. The customer's right to privacy is a separate topic which will not be addressed in this article. For a discussion of some of the leading cases addressing fraud and negligent misrepresentation, see Williamson & Tanner, *supra* note 4, at 22-24. For a recent case imposing liability see MSA Tubular Prod., Inc. v. First Bank & Trust Co., 809 F.2d 1422 (10th Cir. 1989).

certain action with regard to a particular customer.[226] Securities violations may be alleged if the bank is considered to be an insider; the bank may be placed in the awkward position of not being allowed to disclose information under the securities laws, yet being required to make certain disclosures under other principles of law.[227]

2. Practice Observations

There is no legal obligation on the lender to respond to credit inquiries or to supply accommodation letters. The safest approach by which to avoid liability is simply to refuse to respond. This sounds simple, but as a practical matter customers expect these types of services and the world of finance is largely dependent upon the open and accurate exchange of credit information.

Before responding the lender should consider other alternatives. For example, in lieu of giving a letter stating that a customer's checks are good, the lender should suggest the use of certified checks or cashier's checks. Another alternative is to obtain the customer's authorization to place a hold on a certain amount of funds to be used for payment of specified checks.

The following list summarizes the steps lenders should take to reduce their exposure for credit references:[228]

(1) Know the purpose or reason for the credit reference. With knowledge of the purpose of the inquiry or accommodation letter, the lender will be better able to supply information that is meaningful and complete.

(2) Put all credit references in writing. If, because of the urgency of the reference, it is not feasible to submit a written document to the requesting party, then thoroughly document the substance of the conversation in a memorandum to the file.

(3) Explain special terminology used in the reference so that

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[226] *See generally* Robert Morris Associates and the National Associates of Credit Management, *Information on Deteriorating Accounts, reprinted in* I EMERGING THEORIES OF LENDER LIABILITY 407 (1985)(exchange of credit information should be handled with great care)[hereinafter referred to as "Robert Morris Associates"].

[227] *Id.* at 419.

[228] *Id.* For sample responses to credit inquiries, see II EMERGING THEORIES OF LENDER LIABILITY 1496-98 (H. Chaitman ed. 1985).

the response will not be misleading or confusing.

(4) Before responding to any inquiry, check all your files regarding the customer in question. To the extent practicable, make copies or keep a complete record of all documents examined in responding to the credit inquiry. It is also a good idea to speak to as many bank officers as possible who are responsible for administering the customer's differing accounts to be sure that there are no problems which are not reflected in the files. State in your response that it is based upon a review of the bank ledger records and other bank files only—that is, that no investigation has been made in responding to the request. Include a clause in your response which states that other bank files may contain or other bank personnel may have knowledge of contrary information and disclaim any responsibility for the accuracy or completeness of the response.

(5) Limit your response to the *facts*.

(6) Make sure your response is accurate and truthful and that all material facts are disclosed. "[O]ne who responds to an inquiry is guilty of fraud if he denies all knowledge of a fact which he knows to exist, if he gives an equivocal, evasive, or misleading answer calculated to convey a false impression, even though literally true as far as they go, or if he failed to disclose the whole truth."[229] "Telling half a truth has been declared to be equivalent to concealing the other half."[230]

(7) Quantify or otherwise explain your responses to the fullest extent possible so that the inquirer will understand your response. For example, if you say that the customer has an account with a balance in the four figure range, explain what the "four figure range" means, such as accounts with a balance from $1,000 to $9,999.

(8) Do not give your opinions or forecast the future. Although the general rule is that opinions are not actionable, the court might consider a particular statement to be a fact, rather than an opinion as intended by the lender, and the lender may find itself subject to liability as a result.

(9) Do not give investment advice. If the purpose of the in-

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[229] Robert Morris Associates, *supra* note 226, at 427.

[230] *Id.*

quiry is related to the sale or purchase of a security, or related to an acquisition, merger, or some form of asset exchange, the best policy is to decline a response to the inquiry.

(10) Do not give specific loan data, such as compensating balance requirements and interest rates. This policy will reduce allegations of antitrust violations.

(11) Include a statement to the effect that the bank does not provide any information relative to the customer's compliance with any covenants in any loan agreement or other related agreements, except as to payment of principal and interest.

(12) Disclaim any responsibility to update the response. As a practical matter, however, if something contrary comes to the attention of the lender soon after the initial response, the lender should consider updating its original response, especially if the lender knows that the inquirer has not yet taken any action and is still relying upon the original response.

(13) Include a statement to the effect that the inquirer should not rely upon the response in making any decision, but should only consider the information provided in connection with other factors and make its own independent conclusions.

F. Environmental Liability

The Comprehensive Environmental Response, Compensation and Liability Act (CERCLA)[231] imposes liability for clean-up costs upon the current owner and operator of a contaminated facility and upon any person who owned or operated a contaminated facility at the time of disposal of hazardous substances.[232]

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[231] 42 U.S.C. §§ 9601-9656 (1988). CERCLA was extended and amended by the Superfund Amendments and Reauthorization Act of 1986 (SARA). Publ. L. No. 99-499 (codified in scattered sections of 42 U.S.C. (1989)). For a discussion of other environmental laws of potential interest to lenders such as the Clean Air Act and U.S. Army Corps of Engineers permits, see Bell & Dayton, *Environmental Due Diligence in Real Estate Lending Transactions and Conveyances in Lender Liability Law and Litigation*, LENDER LIABILITY LAW AND LITIGATION § 13 (1989).

[232] 42 U.S.C. § 9607(a)(1)(2). Other "potentially responsible parties" (PRP) under CERCLA are persons who by contract or agreement arrange for the disposal of hazardous waste and any person who accepts hazardous waste for transport to the affected site. *Id.* § 9507(a)(3)(4).

Once a party's status as PRP is established, the potential liability can be enormous. The Environmental Protection Agency estimates that the average cost of a single clean

This provision creates a double-edged sword for lenders.[233] If the lender's loans are secured by the contaminated facility, the lender's collateral may be lost or impaired. If the lender is deemed an owner or operator the lender may be held directly liable for clean-up costs.[234]

Section 101 of CERCLA excludes from the definition of owner or operator any person who "without participating in the management of a . . . facility, holds indicia of ownership primarily to protect his security interest in the . . . facility."[235] Three federal district court decisions have considered the scope of this exemption: *United States v. Mirabile*,[236] *United States v. Maryland Bank & Trust Co.*,[237] and *United States v. Fleet Factors Corps.*[238] *Mirabile* involved two lenders, American Bank & Trust Co. and a predecessor in interest to the Mellon Bank N.A., that had provided financing for a paint manufacturing business which generated hazardous wastes. American Bank foreclosed and successfully bid in at the sheriff's sale, but promptly assigned its bid to the Mirabiles, who took control of the property. When the EPA sued the Mirabiles for clean-up cost under CERCLA, they joined American Bank and Mellon as third party defendants, arguing they were owners and operators under CERCLA.[239]

The court granted summary judgment for American Bank, finding that its involvement in the borrower's operations was limited to securing the property, inquiring as to the cost of removal of the waste, showing the property to prospective purchasers and bidding at the foreclosure. The court concluded that these actions were taken solely to protect its security interests in

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up is between $10 and $12 million. Comment, *The Liability of Financial Institutions for Hazardous Waste Cleanup Costs Under CERCLA*, 1988 WIS. L. REV. 139, 140 n.3. Since the enactment of SARA, some have contended the average costs has increased to between $30 and $50 million. King, *Lender's Liability for Cleanup Costs*, 18 ENVTL. L. 241, 266 n.109 (1988).

[233] 1 LENDER LIABILITY NEWS 11, 11 (Nov. 2, 1988).

[234] *Id.*

[235] 42 U.S.C. § 9601(20)(a).

[236] 15 ENVTL. L. REP. 20,994 (E.D. Pa. 1985).

[237] 632 F. Supp. 573 (D. Md. 1986).

[238] 19 ENVTL. L. REP. 20,529 (S.D. Ga. 1988).

[239] *Mirabile*, 15 Envtl. L. Rep. at 20,995.

the property and that CERCLA's security interest exemption applied. Mellon was less fortunate. The court found that it had made frequent visits to the plant, involving itself with manufacturing changes, personnel assignments and even daily supervision of the facility's operations. The court reasoned that these activities went beyond mere concern over the financial affairs of the borrower and amounted to involvement in the management-operations of the facility, rendering the security interest exemption inapplicable.[240]

In *Maryland Bank & Trust Co.*, the court held that Maryland Bank & Trust Co. had become an owner of a hazardous waste facility by purchasing the facility at the bank's foreclosure sale.[241] The court concluded the security interest exemption was inapplicable because the mortgage representing the lender's security interest terminated at the foreclosure and "ripened into full title"[242] when the lender purchased the facility.[243] The court concluded that *Mirabile* was distinguishable because American Bank had promptly assigned the property to the Mirabiles.[244]

In *Fleet Factors*, the court held that some Fleet Factors Corp. activities fell within the security interest exception, but that others did not. Fleet entered into a factoring agreement with Swainsboro Paint Works (SPW) in which Fleet agreed to advance funds against the assignment of SPW's accounts receivable. As collateral Fleet obtained a security interest in SPW's

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[240] *Id.* at 20,995-20,997.

[241] *Maryland Bank & Trust Co.*, 632 F. Supp. at 577-80.

[242] *Id.* at 579. The court offered a public policy justification for its holding:

> Under the scenario put forward by the bank, the federal government alone would shoulder the costs of cleaning up the site, while the former mortgagee-turned-owner would benefit from the clean-up by the increased value of the unpolluted land. At the foreclosure sale, the mortgagee could acquire the property cheaply. All other prospective purchasers would be faced with potential CERCLA liability and would shy away from the sale. Yet once the property had been cleared at the taxpayer's expense and become marketable, the mortgagee-turned-owner would be in a position to sell the site at a profit.

Id. at 580.

[243] *Id.* at 579.

[244] *Id.* at 580. The court declined to rule on the issue of "whether a secured party which purchased the property at a foreclosure sale and then promptly resold it would be precluded from asserting," *id.* at 579 n.5, the security interest exception, *id.*

plant, equipment, inventory and fixtures.[245] Fleet checked the credit of SPW's customers before SPW shipped finished goods to them.[246]

SPW encountered financial problems and filed for reorganization under Chapter 11 of the Bankruptcy Code. With the bankruptcy court's approval, Fleet continued to provide financing. Ultimately, however, Fleet discontinued its financing and SPW ceased operation at its plant. SPW concluded its operations by selling off inventory and turning the proceeds of its receivables over to Fleet.[247]

Fleet never foreclosed on its interest in the plant. It did, however, foreclose on its security interest in the equipment and some of the inventory. Fleet sold some of the equipment and inventory at auction and retained a firm to remove the remaining equipment from the plant.[248]

The court rejected the government's argument that Fleet's action prior to the foreclosure made it an owner or operator. The court concluded that the security interest exemption permitted secured creditors to provide financial assistance, general management advice, and even isolated instances of specific management advice to its debtors without risking CERCLA liability if the secured creditor did not participate in the day-to-day management of the business or facility either before or after the business ceased operation.[249]

The court also held, however, that the government's contention that Fleet's agents had become involved in the management of the company between the auction and final removal of inventory and equipment created a fact issue precluding summary judgment for Fleet. The government alleged that during this period Fleet's agents moved barrels of toxic chemicals and knocked loose asbestos within the plant.[250]

Firm conclusions about lenders' liability under CERCLA are difficult to draw from these cases. *Mirabile* holds that a

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[245] *Fleet Factors Corp.*, 19 Envtl. L. Rep. at 20,539.
[246] *Id.* at 20,530-20,532.
[247] *Id.*
[248] *Id.*
[249] *Id.*
[250] *Id.*

lender that acquires title temporarily through foreclosure, then promptly transfers its interest to a third party, is not an owner or operator. The practical effect of the holding, however, was limited by amendments to CERCLA adopted by Congress in 1986.[251] These amendments impose liability upon prior owners of a facility unless the owner qualifies as both an innocent landowner and as an innocent land seller. To qualify as an innocent landowner, a prior owner must establish that he "did not know and had no reason to know that any hazardous waste which is the subject of the release or threatened release was disposed of on, in, or at the facility."[252] This standard is met only if the previous owner undertook at acquisition "all appropriate inquiry into the previous ownership and uses of the property consistent with good commercial or customary practice in an effort to minimize liability."[253] The prior owner is not an innocent seller and is subject to liability under CERCLA if he learns of a contamination problem and transfers ownership of the facility to another person without disclosing the problem.[254] Commercial lenders foreclosing on property will have difficulty avoiding liability under these standards.[255]

Both *Mirabile* and *Fleet* distinguished between financial and operational involvement in a facility's management in determining the applicability of the security interest exception. It has been persuasively suggested that, unless a lender totally dominates a borrower's management, CERCLA liability should not be imposed.[256] Until more case law develops, however, the standard of liability will remain unclear.[257]

While no precise rules can be laid down, prudent lenders

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[251] J. NORTON & W. BAGGETT, *supra* note 3, § 12.03[a][b].

[252] 42 U.S.C. § 9601(35)(A)(i).

[253] *Id.* § 9601(35)(B). CERCLA specifies factors governing the adequacy of the investigation, including specialized knowledge and experience, commonly known or reasonably obtainable information and ability to detect through inspection. *Id.* § 9601(35)(C).

[254] *Id.* § 9601(25)(C).

[255] J. NORTON & W. BAGGETT, *supra* note 3, at 12.03[2][b].

[256] Tom, *Interpreting the Meaning of Lender Management Participation Under Section 101(20)(A) of CERCLA*, 98 YALE L.J. 925, 928 (1989); *see also* Burcat, *Environmental Liability of Banks, Creditors and Other Deep Pockets*, 103 BANKING L.J. 509, 537-38 (1986) (outlining activities that are management directed rather than financial).

[257] J. NORTON & W. BAGGETT, *supra* note 3, at 512.03[1].

can and should take steps to avoid the double-edged sword created by environmental laws. Every lender should develop a comprehensive policy governing environmental matters. That policy should make provision for investigation of a borrower's compliance with environmental laws and regulations.[258] The loan documentation should routinely include:

1) Representations and warranties as to past activities and present conditions;[259]

2) Express covenants obligating the borrower to comply with all environmental laws and to keep the lender advised as to the borrower's environmentally sensitive activities on the property and to provide notices of cleanup orders or assessments;[260] and

3) Indemnification provisions holding the lender harmless for any cleanup costs assessed against it solely for reason of its status as a secured lender on the property.[261]

Caution should be used in drafting provisions which might be deemed to give the lender control over the borrower's day-to-day management of his business lest the lender fall victim to a situation similar to that encountered in *Mirabile*.[262]

Foreclosure resulting in fee simple title to the lender can be a mistake. The lender should investigate carefully before foreclosing on property that may be contaminated or before removing other collateral from such property.[263]

G. Waivers: The Landlord, Mortgagee and Warehouseman Dilemmas

Lenders are regularly faced with situations where a borrower desires to take or install property on rented or mortgaged

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[258] *Id.* For detailed checklists of the kind of investigation lenders should undertake, see 1 LENDER LIABILITY NEWS 9 (Nov. 16, 1988); 1 LENDER LIABILITY NEWS 11 (Nov. 2, 1988); 1 LENDER LIABILITY NEWS 9 (July 27, 1988). The Federal National Mortgage Association (Fannie Mae) has formulated special environmental hazards procedures that lenders must follow in securing commitments for Fannie Mae loans.

[259] King, *supra* note 232, at 286.

[260] *Id.* at 287.

[261] CERCLA prohibits an outright transfer of liability but permits indemnity agreements. 42 U.S.C. § 9607(e).

[262] King, *supra* note 232, at 288.

[263] *See supra* notes 241-250 and accompanying text.

premises that otherwise constitutes collateral to the lender. If the lender with the security interest in the particular piece of property later tries to take the property in satisfaction of the debt, the lender may find himself in opposition to a landlord or mortgagee who also claims a right to the property.

As to leased premises, Mississippi law gives the landlord the right to distrain personal property of the tenant for unpaid rent.[264] As to the mortgagee situation, the mortgagee may argue that the property installed on the premises has become a fixture within the meaning of the U.C.C. and cannot be removed because the mortgagee has priority to the fixture due to the prior recorded mortgage.[265]

The lender's solution is to obtain a landlord's waiver or mortgagee's waiver (as appropriate in the particular circumstances). This waiver will protect the lender's security interest in the collateral. At a minimum, the waiver should include the following:

(1) An acknowledgment by the landlord or mortgagee that the lender has priority to the property;

(2) A representation that (a) the landlord or mortgagee waives or subordinates all rights it has to the property, including but not limited to contractual, possessory and/or statutory rights and (b) that the landlord or mortgagee does not and will not consider the property to be or become fixtures;

(3) An acknowledgment by the landlord or mortgagee that the lender is relying upon the foregoing representations;

(4) An agreement that the lender may enter upon the premises at reasonable times to inspect the collateral;

(5) An agreement by the landlord or mortgagee to advise

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[264] MISS. CODE ANN. § 89-7-55 (1972) provides:

> An attachment or distress may be sued out by the lessor of lands, his executors, administrators, or assigns. It may be had for rent of the leased premises due and in arrear, or to become due, as the case may be, and for advances made by the landlord or his administrator or executor for supplies for the tenant and others for whom the tenant may have contracted and for his business carried on upon the leased premises.

Id.

[265] MISS. CODE ANN. § 75-9-313(7) (1972) provides, "In cases not within the preceding subsections, a security interest in fixtures is subordinate to the conflicting interest of an encumbrancer or owner of the related real estate who is not the debtor." *Id.*

the lender if the borrower should default in its obligations under the lease or mortgage;

(6) An agreement by the landlord or mortgagee that, in the event of default with respect to the collateral, the landlord or mortgagee: (a) can enter upon the premises to repossess the property and (b) the lender may have a reasonable period of time (preferably a stated number of days) to accomplish the removal of the property; and

(7) An agreement that the landlord or mortgagee will not interfere in any way with the rights of the lender to the collateral and that the landlord or mortgagee will inform any successor in interest of the terms of the waiver.

Where the borrower plans to take the property on leased premises which is also subject to a mortgage, the lender should get the landlord's waiver from the landlord *and* the mortgagee's waiver from the mortgagee of the leased premises.[266]

Another situation similar to that of the landlord/tenant is where the lender holds as collateral goods that are to be stored with an independent warehouseman. Like the landlord, in Mississippi the warehouseman has a lien on the stored goods for unpaid storage fees.[267] In such a situation, the lender should obtain

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[266] For a complete discussion of the Landlord's Waiver and Mortgagee's Waiver, see Weissman, *supra* note 192, at 138-41; W. HILLMAN, *supra* note 196, at 189-95; R. NASSBERG, THE LENDER'S HANDBOOK, 34-35 (1986).

[267] MISS. CODE ANN. § 75-7-209 (1972) provides:

> (1) A warehouseman has a lien against a bailor on the goods covered by a warehouse receipt or on the proceeds thereof in his possession for charges for storage or transportation (including demurrage and terminal charges), insurance, labor, or charges present or future in relation to the goods, and for expenses necessary for preservation of the goods or reasonably incurred in their sale pursuant to law. If the person on whose account the goods are held is liable for like charges or expenses in relation to other goods whenever deposited and it is stated in the receipt that a lien is claimed for charges and expenses in relation to other goods, the warehouseman also has a lien against him for such charges and expenses whether or not the other goods have been delivered by the warehouseman. But against a person to whom a negotiable warehouse receipt is duly negotiated a warehouseman's lien is limited to charges in an amount or at a rate specified on the receipt or if no charges are so specified then to a reasonable charge for storage of the goods covered by the receipt subsequent to the date of the receipt.
>
> (2) The warehouseman may also reserve a security interest against the bailor for a maximum amount specified on the receipt for charges other than

a warehouseman's waiver, which includes essentially the same provisions set forth earlier as to the landlord's waiver and mortgagee's waiver. Additionally, however, the warehouseman's waiver should provide that the warehouseman agrees, upon notice by the lender that a default has occurred, not to deliver any part of the inventory to the borrower and also that any insurance proceeds paid as a result of the warehouseman's insurance coverage shall be payable jointly to the borrower and lender.[268]

III. General Loan Provisions

The documents necessary to accomplish a particular loan transaction will vary depending upon the nature of the loan. A simple promissory note may be all that is required. On the other hand, there may be a loan agreement, a security agreement, a deed of trust, or U.C.C. financing statements, with each document designed to perform a specific function.

The purpose of this section, "General Loan Provisions," is to discuss certain items that may appear in many different kinds of documents, without restricting the discussion to a particular type of loan transaction.

The key in drafting all loan agreements is to insure that every provision has a specific purpose. One should avoid boilerplate language,[269] but avoiding boilerplate is not the same as re-

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those specified in subsection (1), such as for money advanced and interest. Such a security interest is governed by the chapter on Secured Transactions (Chapter 9).

(3) A warehouseman's lien for charges and expenses under subsection (1) or a security interest under subsection (2) is also effective against any person who so entrusted the bailor with possession of the goods that a pledge of them by him to a good faith purchaser for value would [sic] have been valid but is not effective against a person as to whom the document confers no right in the goods covered by it under Section 7-503 [§ 75-7-503].

(4) A warehouseman loses his lien on any goods which he voluntarily delivers or which he unjustifiably refuses to deliver.

Id.

[268] Weissman, *supra* note 204, at 153.

[269] Some studies have shown a direct correlation between the use of boilerplate agreements and loan losses. *See, e.g.*, Kraemer & Case, *Loan Documentation: Structuring and Documenting the Loan to Avoid Future Problems and Loan Administration: Maintaining the Benefit of Loan Terms*, I ALI-ABA Course of Study, Lender Liability Defense and Prevention 19 (1987)(correlation between boilerplate and losses).

fusing to use forms. Without the use of forms, the cost of lending would skyrocket, and therefore standard forms serve an extremely important function by allowing loans to be processed at a reasonable cost to both the lender and borrower. However, not every loan transaction is suited to a standard form, and the lender should always consider whether a tailor-made loan document is more appropriate. Irrespective of whether the loan document is a standard form or tailor-made, the lender should always be totally familiar with and understand every provision in the document. The rule of thumb should be the following: If a provision has no purpose, it should be deleted.

The ultimate goal is twofold: (1) draft a loan document that, on its face and without the necessity of any construction or interpretation, will accomplish what is necessary in the particular instance at a reasonable cost to both the lender and borrower, and (2) ensure that the lender's rights and remedies are protected at all times by the agreement irrespective of the stage of the loan (that is, the ordinary course of the loan agreement, workout after default, and bankruptcy).[270]

The first goal will be discussed in more detail later. With regard to the second goal, a wise lender will insure that the borrower's rights and remedies are adequately set forth in the loan documents as well. Traditionally, lenders have drafted loan documents from the offensive approach—that is, documents were intended to set forth what the *lender* could do in the course of the loan, with special emphasis on the lender's rights upon default by the borrower. Now, it is equally important that lenders draft loan documents with a defensive approach in mind. Today, loan documents should appear to be balanced—that is, the documents should reflect that the borrower's rights and remedies have been considered, as well as the lender's. The problem in many of the lender liability cases has been that, in those instances where the borrower's rights were not adequately addressed in the loan documents, the court read additional terms (such as good faith) into the loan documents. The authors urge lenders and borrowers to resolve the matters discussed in this section during negotiation and expressly provide for their treat-

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[270] R. NASSBERG, *supra* note 206, at 1-4.

ment in the loan documents, rather than leaving terms open or ambiguous and thereby subjecting themselves to judicial second-guessing.

A. The "Definitions" Section

Loan documents typically include a definitions section. The goal of the definitions section relates back to the first goal set forth earlier—that is, that the document will accomplish the intended purpose *without* the necessity of any interpretation. If the document is truly to be the only source which sets forth the rights of both parties, then the words used must mean the same to all readers. The definitions section is designed to accomplish this objective by expressly stating the meaning of words or phrases that *could* mean different things to different people.

As a matter of necessity, certain terms will routinely be included in the definitions section. However, in defining a few terms, lenders should be especially cautious that certain pitfalls are avoided. Terms which are usually included in the definitions section but which can create problems for lenders are discussed below.

1. Interest

The formula by which lenders calculate interest has resulted in disputes with borrowers. There are three commonly used bases: (1) the 360/360 method,[271] (2) the 365/365 method[272] (or 366

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[271] Under the 360/360 method, interest may be calculated in one of two ways:

(1) (annual interest rate / 12)
x
outstanding principal amount
x
number of months outstanding;

or

(2) (annual interest rate / 360)
x
outstanding principal amount
x
number of assumed days in the payment period.

Under this method, it is assumed that every month contains at least thirty days. *The Committee on Developments in Business Financing of the Section of Corporation, Banking and Business Law, American Bar Association*, TERM LOAN HANDBOOK 41-42 (J. McCann, ed. 1983)[hereinafter TERM LOAN HANDBOOK].

[272] *Id.* at 41. The interest formula under the 365/365 method is:

in leap years), and (3) the 365/360 method.[273] To avoid any dispute, lenders should specify which method is used to calculate the interest due. Especially on large loans, the difference in interest may be significant and may be financially worthwhile to the borrower to debate.

Interestingly, at least one suit has been filed against a lender as a result of raising the interest rate charged on loans. In *Shiplet v. First Security Bank of Livingston, Inc.*,[274] the Shiplets borrowed money at a rate of ten percent to finance their ranching operations. Thereafter, they made several other new loans and also rolled over some outstanding indebtedness into new loans.[275] Because of the rise in interest rates generally, the bank increased the interest rates as new loans were issued, up to a rate as high as 21.5%.[276]

The Shiplets sued the bank, alleging a multitude of theories,[277] most notable of which were claims for breach of fiduciary

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(annual interest rate / 365)
x
outstanding principal amount
x
actual number of days outstanding.

Id. If a loan is outstanding for a full calendar year, the computations under the 360/360 method and the 365/365 method will result in the same interest. *Id.*

[273] *Id.* at 42. The 365/360 method calculates interest as follows:

(annual interest rate / 360)
x
outstanding principal amount
x
actual number of days outstanding.

If a loan is outstanding for a full year, this calculation will result in a slightly higher interest payment, since interest is assessed based on a year of 360 days. *Id.* at 42. Although this method is commonly used by banks, borrowers who were unaware that this was the intended method for calculating interest have sued lenders, alleging usury violations and breach of contract. *Id.* at 43.

[274] 762 P.2d 242 (Mont. 1988).

[275] *Shiplet*, 762 P.2d at 242.

[276] *Id.*

[277] *Id.* The plaintiff's claims included breach of contract, fraud, negligent infliction of emotional distress, breach of a third-party beneficiary contract, and bad faith. *Id.*

duty and economic duress.[278] The court rejected the claim for breach of fiduciary duty on the grounds that it found no special circumstances to warrant imposition of such a duty on the bank. Although the bank had advised the Shiplets about their ranching operations, they often disregarded such advice. Likewise, the court rejected the claim of economic duress. The Shiplets argued they had no alternative but to sign the notes, since otherwise, the bank would have foreclosed on the property. The court concluded that there can be no economic duress where consent is obtained through insistence upon one's legal rights, such as foreclosure.

2. Prime Rate

For many years, prime rate was a term understood without any explanation. Now, a lender who fails to define prime rate is a prime target for litigation. This problem surfaced when certain borrowers who were paying the full prime rate contended that they realized that banks were lending to other customers at a discounted prime rate. Borrowers who were paying full prime rate were led to believe that they were getting the best possible rate, when in fact they were paying a premium. As a result, class action suits have been brought with allegations including breach of the duty of good faith,[279] fraud, racketeering, antitrust violations, usury and unfair practices.[280]

Two cases, *Kleiner v. First National Bank*,[281] and *Haroco, Inc. v. American National Bank & Trust Co.*,[282] illustrate how

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[278] *Id.*

[279] *See, e.g.*, Kleiner v. First Nat'l Bank, 581 F. Supp. 955 (N.D. Ga. 1984)(class action suit involving alleged breach of duty of good faith).

[280] *See, e.g.*, Michaels Bldg. Co. v. Ameritrust Co., N.A., 848 F.2d 674 (6th Cir. 1988) (class action involving RICO and Sherman Act violations), *discussed in* Lobenfeld, *Lender Liability Litigation Recent Developments: Claims under Federal Law—RICO, Antitrust, Bank Holding Company Act*, LENDER LIABILITY LITIGATION 1988 271, 332 (Practicing Law Institute 1988); NCNB National Bank v. Tiller, 814 F.2d 931, 935 (4th Cir. 1987)(plaintiffs alleged bank's application of prime rate constituted fraud, violation of RICO and violation of South Carolina Unfair Trade Practices Act); *see also* Mannino, *The Lessons of the Prime Rate Cases*, 14 LENDER LIABILITY NEWS 1, 1-2 (Jan. 11, 1989) (discussing the changing theories behind prime rate litigation).

[281] 581 F. Supp. 955 (N.D. Ga. 1984).

[282] 747 F.2d 384 (7th Cir. 1984).

far borrowers reach to challenge interest rates.

In *Kleiner*, a group of borrowers alleged that the bank's failure to charge interest in accordance with the manner set forth in the notes constituted a breach of an implied obligation of good faith.[283] Since the interest rates on the loans in question were based on the bank's own prime lending rate, the United States District Court for the Northern District of Georgia concluded that the bank was bound by an obligation of good faith in setting its prime rate.[284] The court opined that "where an agreement permits one party to unilaterally determine the extent of the other's required performance, an obligation of good faith in making such a determination is implied."[285]

In *Haroco*, the borrowers alleged that the bank "fraudulently maintained an inflated prime rate,"[286] which constituted RICO violations, as well as a breach of contract. The defendants argued that the allegations in a RICO claim must be as specific as a criminal bill of particulars.[287] The court disagreed, noting that a civil plaintiff has no pre-complaint discovery rights and should not be required to essentially plead the evidence and prove the case in the complaint.[288] Accordingly, the court ruled that the plaintiffs had set forth enough facts to assert a RICO claim[289] and denied the bank's motion for summary judgment.[290]

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[283] *Kleiner*, 581 F. Supp. at 957.

[284] *Id.* at 958.

[285] *Id.* at 960. However, the court denied the borrowers' motion for partial summary judgment on the basis that the issue of whether the bank set the notes in good faith was a fact issue for the jury. *Id.*; *see also Lender Liability for Breach of the Obligation of Good Faith Performance*, 36 EMORY L.J. 917, 944-45 (1987) (discussion of *Kleiner*).

[286] *Haroco*, 747 F.2d at 385. The loans in question had stated interest rates of one percent above the bank's prime rate, which was defined as the " 'rate of interest charged by the bank to its largest and most creditworthy commercial borrowers for 90-day unsecured commercial loans.' " *Id.*

[287] *Id.* at 403.

[288] *Id.* at 404.

[289] *Id.* at 405. The court noted:

> In this case, the complaint adequately specified the transactions, the content of the allegedly false representations, and the identities of those involved. In addition, the identification of the transactions and the description of the alleged scheme to defraud put defendants on fair notice of the time and place of the alleged false representations. . . . There would have been little point in requiring plaintiffs to expand the complaint by also identifying each notice which included an interest rate.

To reduce the risk of liability where the interest rate to be charged is somehow tied to prime rate, the best solution is to define prime rate as "that rate of interest from time to time announced by the Bank as its 'prime rate.' "[291] Also, it is recommended that the customer be fully informed as to the manner in which the bank announces its prime rate and how the customer can find out what the rate is.

When the interest rate on a loan is subject to change, as in instances where it is tied to prime rate, it is also a good practice to routinely include a clause to the effect that the interest rate shall not exceed the maximum allowed by law. One author also suggests including a provision to the effect that "[i]f any sum is collected in excess of the applicable maximum rate, the excess collected shall be applied to reduce the principal debt."[292] Otherwise, a lender might find itself subject to allegations of usury violations and in some states might lose its right to both principal and interest, as well as other penalties.[293]

3. The Collateral

If the loan is to be secured, it is critical that the collateral be adequately defined. Otherwise, the borrower may argue that certain items were not intended to be collateral, while the lender asserts a right to such items. The lender should not rely upon general descriptions, but to the extent practicable should define

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Id.

[290] *Id.*

[291] R. NASSBERG, *supra* note 206, at 11.

[292] W. HILLMAN, *supra* note 206, at 82-83. If the loan documents include a prepayment penalty, then the aforementioned provision should include a statement to the effect that in such a case the prepayment penalty would not apply.

[293] *Id.* As a matter of routine practice, every loan document should also include a conflicts of law provision. In other words, a clause should be included which specifies the controlling state law. Such a provision may sometimes save what would otherwise be a usurious agreement. *Id.* Mississippi will recognize such provisions as long as the state specified is reasonably related to the transaction. *See, e.g.*, Armstrong v. Alliance Trust Co., 88 F.2d 449, 451 (5th Cir. 1937) ("Such an agreement contractually adopts the law selected and ought to control as the will of the parties unless forbidden by some statute or public policy that would otherwise govern."). A typical conflicts of law provision might read: "This Agreement and each Note shall be deemed to be a contract made under the laws of the State of Mississippi and for all purposes shall be governed by the laws of that state." *See generally*, W. HILLMAN, *supra* note 206, at 61 (conflict of laws provision).

items of collateral more particularly. This is critical, for example, where inventory is intended to secure a loan. Does inventory include work in process and goods shipped out on consignment?

This same concept applies where the amount available for loan is specified as a percentage, such as eighty percent of accounts receivable. The definition of accounts receivable is important because the lender usually wants the right to assess the collectability of accounts receivable and allow as a borrowing base only those accounts that are creditworthy.

Although the U.C.C. defines certain terms such as "accounts," "inventory," and "equipment,"[294] the lender may wish to be more specific, by including *without limitation* certain specific items as collateral. Of course, this approach can be overdone as well. If the lender includes a long list of items, the court may refuse to include as collateral other items which might otherwise have been treated as collateral had a general classification been used.

4. Financial Tests

Loan documents may require that certain financial tests be satisfied before the bank is obligated to loan any money.[295] Additionally or alternatively, the loan agreement may require the borrower to satisfy certain financial tests on an ongoing basis, the violation of which results in a default under the loan. For example, the borrower may be required to maintain a certain level of current assets or net working capital, or the loan may specify that current liabilities shall not exceed a specified amount. Any time financial tests are included as a part of the loan agreement, such terms should be clearly defined and should be tied to generally accepted accounting principles (GAAP) applied on a consistent basis. However, the lender should not rely solely on GAAP to protect its interests, since with regard to certain items GAAP may not properly accomplish the lender's goals.[296] For example, assume the borrower has $100,000 in an

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[294] U.C.C. § 9-106; *id.* § 9-109 (1987).

[295] A provision of this kind is referred to as a condition precedent. For a more complete discussion of conditions precedent, see *infra* notes 298-300 and accompanying text.

[296] *See supra* note 200 (regarding documentation needs).

account, but the account is held by Bank *A* as security for a loan with that bank. GAAP will treat that account as cash. If Bank *B* wants to loan money to that same borrower and require the borrower to maintain a specified cash balance, Bank *B* may not wish to include the $100,000 already securing the loan at Bank *A* as cash. Therefore, it is critical that the cash balance which is required by the loan be adequately defined.[297]

5. Availability of Funds

For the same reasons that the method of calculating interest makes a difference, the time at which loaned funds will be available to the customer is significant. The loan documents should clearly set forth whether funds will be immediately available to the customer upon the signing of the loan documents or whether overnight availability is anticipated.

B. Conditions Precedent

Loan agreements usually include certain conditions which must be met *before* the bank is obligated to advance money under the loan agreement. These requirements are referred to as conditions precedent.[298] If the conditions are satisfied, the bank *must* advance the money, and failure to do so may result in liability of the bank to the customer. Like all other loan provisions, the key with regard to conditions precedent is to insure that the stipulations are unambiguous. The condition itself should be

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[297] Problems may also arise where there is a change in GAAP. For a discussion of this problem, see R. TIGHE, STRUCTURING COMMERCIAL LOAN AGREEMENTS ¶ 6.01[3] (1984).

[298] *Id.* ¶ 2.01[2]. One author has categorized the common conditions precedent as follows:

> (1) Delivery of requisite documents — note, guaranty, subordination, security agreement, pledge.
> (2) Verification of requisite approvals — resolutions of the borrower's board of directors, waivers and consents by creditors, governmental approvals.
> (3) Completion of all specified actions — contribution to capital, completion of an acquisition, obtaining of additional credit.
> (4) Compliance with the law — Federal Reserve Form U-1.
> (5) Verification of assumptions — an opinion of borrower's counsel, certificate of no default.

Id.

clearly stated, as well as the time period from which fulfillment of the condition will be measured. Any matter that would alter the bank's willingness to lend money should be stated as a condition precedent to protect the bank from the requirement of lending money in the event the customer's position changes between the initial date of negotiation and the loan closing. Moreover, a statement should be included in the loan documents that both parties (lender and borrower) acknowledge that all conditions precedent are material to the loan transaction and that strict compliance with all conditions precedent is required before the bank's obligation to lend arises.

A condition precedent to many loan transactions is the requirement that a satisfactory opinion from the borrower's legal counsel be furnished to the lender. The purpose of this opinion is to obtain a statement from the borrower's own counsel that the loan documents constitute a legal, valid and binding obligation of the borrower and that the documents are enforceable in accordance with the stated terms.[299] In requiring an opinion from the borrower's legal counsel, the lender should clearly address two issues: (1) the form of opinion required and (2) who may issue the opinion. With regard to the form of opinion, the lender is best protected if the actual required form of opinion is attached to the loan agreement as an exhibit. This approach eliminates any controversies regarding what constitutes a satisfactory opinion. With regard to who may issue the opinion, the lender should specify whether in-house counsel, local counsel, or special independent counsel is required to render the opinion.[300]

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[299] *See* MacKinnon & Eisler, *Drafting Lending Documents to Avoid Lender Liability Claims*, LENDER LIABILITY LITIGATION 1988, at 729, 756-58 (Practicing Law Institute 1988) (opinion should include exceptions for bankruptcy provisions and equitable principles of law such as principles of good faith and fair dealing). Another author has suggested that the simple act of obtaining an opinion from the borrower's counsel helps to establish the bank's prudence and good faith in entering into the loan transaction. R. TIGHE, *supra* note 297, ¶ 2.02[5][a][i]. Such an opinion should certainly help to counter any allegations of overreaching by the lender.

[300] *See generally* R. TIGHE, *supra* note 297, ¶ 2.02[5][a] (designation of issurer suggested).

C. *Representations and Warranties*

Representations and warranties are statements of fact made by the borrower to induce the bank to loan money and upon which the lender expressly relies in issuing the loan. Certain representations and warranties are generally required as a matter of course, such as:

(1) representations that a corporation is duly incorporated and in good standing and that the officers requesting the loan have the power to act and the authority to bind the corporation;

(2) that the prospective borrower's financial statements which are provided to the bank for consideration in deciding whether to issue the loan are true and correct and reflect or describe fully all contingent obligations (such as potential liabilities for pending litigation); and,

(3) that neither the borrower's corporate documents nor contracts to which the borrower is already a party will prevent the borrower from fulfilling its obligations under the loan agreement.[301]

Representations and warranties present a multi-faceted problem: they benefit the lender, in that they set forth the assumptions upon which the lender is relying in entering into the loan agreement; they force the borrower to carefully examine all the matters covered by the representations and provide the lender with complete information; and finally, they evidence the lender's good faith in entering into the loan transaction. The disadvantage is that, although the borrower cannot later take a position inconsistent with the representations, the lender is also bound by the representations and cannot later object to any facts which were covered by the representations.

As a general rule, representations and warranties need only be true on the date the loan agreement is signed. If the lender desires for the representations and warranties to be true on a continuing basis, then a covenant to that effect should be included in the loan documents.[302] Moreover, in situations where the lender may advance additional funds in the future, it is im-

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[301] *Id.* ¶ 3.01-.16 (excellent discussion of various representations and warranties that are typically found in loan agreements and sample provisions of each type).

[302] For a discussion of covenants, see *infra* notes 305-57 and accompanying text.

perative that a condition precedent be included in the loan documents which states that all representations and warranties will be true at the time each future advance is made. The loan documents may or may not (but should) provide that a false representation or warranty is an act of default. At a minimum, if the bank loans money on the basis of a representation or warranty which turns out to have been false, the bank may have a cause of action against the borrower for misrepresentation.

Borrowers are often hesitant to attest to absolute representations and warranties because of the adverse consequences of an untrue statement. Accordingly, borrowers routinely request that representations and warranties be limited by terms of materiality and/or knowledge.[303] The materiality limitation makes an untrue representation or warranty an event of default only if the representation or warranty is materially untrue. Such a limitation is reasonable, although use of the term material without any definitional perimeters can lead to controversies regarding whether a breach is really material. The knowledge limitation alters the absolute truthfulness of the representations and warranties to one that the representations and warranties are true *to the borrower's knowledge*. This means that if a representation or warranty is false, but the borrower had no knowledge of the untruthfulness, then the borrower has committed no breach of the loan documents. The knowledge limitation can greatly impair the lender's rights because it requires that the lender be able to show that the borrower *knew* of the falsity of a representation or warranty. Although the knowledge limitation is not recommended as to every representation and warranty, there are certain representations which may reasonably be limited by the knowledge requirement, such as a representation that there is no threatened litigation against the borrower. In some instances it may be appropriate to permit a representation to be qualified by the borrower's knowledge so long as the borrower warrants the accuracy of the matter covered.[304]

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[303] *See generally* R. TIGHE, *supra* note 297, ¶¶ 3.01[5][a]-.01[5][b] (discussion of borrower's representations and warranties).

[304] The clause could then read: "Borrower represents to his best knowledge but warrants without respect to his knowledge that . . . ."

D. Covenants: Thou Shall and Thou Shall Not

Loan documents are generally filled with covenants which set forth what the customer must do (affirmative covenants) and must not do (negative covenants). Furthermore, the loan documents will generally include a clause that a breach of any covenant constitutes an act of default.

Regardless of whether a covenant is phrased in terms of required or prohibited action, the purpose of all covenants is the same: to protect the bank's investment by establishing criteria for the operation of the borrower's business.[305] "The covenants seek to maintain the borrower's existence, preserve its net worth, maintain the quality of the borrower's assets, assure an adequate cash flow to the borrower, and control the borrower's growth."[306]

Although covenants serve an essential function, lenders should be cognizant of their downside: covenants may be used against the lender to show that the lender exercised excessive control over the borrower. As a result, the lender could be liable to the borrower itself or to the borrower's shareholders and/or creditors. Additionally, the lender's rights may be subordinated to the rights of other creditors, or the lender may be found to be an insider under bankruptcy laws and/or securities laws.[307] As such, in drafting covenants, the lender should strive to "balance its need for protection against the borrower's need to operate its business without restrictions."[308]

1. Compensating Balances

By inclusion of a covenant, the lender may require the borrower to maintain what is known as a compensating balance. In other words, the borrower may be required to maintain a certain level of deposits on hand with the lending institution; for example, the requirement may be that twenty percent of the outstanding loan balance must be maintained in a deposit account at the lending bank at all times.

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[305] R. TIGHE, *supra* note 297, ¶ 4.01[2][a].

[306] *Id.*

[307] *See generally id.*, ¶ 5.01[2] (discussion of bank control); Williamson & Tanner, *supra* note 4, at 67-74 (discussion of equitable subordination).

[308] R. TIGHE, *supra* note 297, ¶ 4.01[3].

The lender may require compensating balances for several reasons. First, the lender may not really be interested in loaning money to the customer at the agreed rate of interest. By requiring a compensating balance, the lender has in effect increased its yield on the loan. The lender will have use of the deposited funds during the loan period, perhaps at no rate of interest or a low rate. Secondly, by requiring a deposit account, the lender may be able to keep a better watch on the financial affairs of the customer. For example, if the deposit account is a checking account, the lender will have access to the checking records and may foresee any financial difficulties the customer may have through review of the deposits and payments. Finally, a mandatory account allows the lender access to funds which might not otherwise be available for purposes of setoff, thereby reducing the bank's risk of loss.

Although the foregoing reasons appear sound, compensating balances are nevertheless fraught with potential problems. First, the borrower may argue that compensating balances combined with the stated interest rate on the loaned money result in usury violations. In light of Mississippi's broad usury language, lenders should be cautious.[309] Additionally, some authors have expressed concern that this requirement may constitute a tying arrange-

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[309] MISS. CODE ANN. § 75-17-25 (Supp. 1987). The statute defines "finance charge" as including:

> [T]he amount or rate paid or payable, directly or indirectly, by a debtor for receiving a loan or incident to or as a condition of the extension of credit, including, but not limited to, interest, brokerage fees, finance charges, loan fees, discount, points, service charges, transaction charges, activity charges, carrying charges, time price differential, finders fees or any other cost or expense to the debtor for services rendered or to be rendered to the debtor in making, arranging or negotiating a loan of money or an extension of credit and for the accounting, guaranteeing, endorsing, collecting and other actual services rendered by the lender; provided, however, that recording fees, motor vehicle title fees, attorney's fees, insurance premiums, fees permitted to be charged under the provisions of Section 79-7-7 [interest on judgments and decrees], and with respect to a debt secured by an interest in land, bona fide closing costs and appraisal fees incidental to the transaction shall not be included in the finance charge.

Id. Despite the broad definition of "finance charge," as a practical matter Mississippi has no usury law with respect to contracts entered into after July 1, 1988, for which the principle balance exceeds $25,000. *See* MISS. CODE ANN. § 75-17-1(5) (Supp. 1989) (debtor may contract for *any* finance charge in certain instances).

ment or restraint on trade in violation of antitrust laws.[310]

If the loan agreement is to include a compensating balance requirement, the lender should ensure that:

(1) The type of account to be maintained is unambiguously defined (checking account and time deposit such as a certificate of deposit);

(2) The manner in which the required balance is determined should be specifically stated (for example, twenty percent of the outstanding principal loan balance); and,

(3) The consequences of failure to maintain the compensating balance are carefully and clearly set forth.

With regard to the consequences of failure to maintain a compensating balance, one author has suggested a solution which should successfully counter any arguments of antitrust violations. Specifically, the loan agreement should state that the interest rate offered on the loan is based upon the assumption that the borrower will maintain the required balances and that the stated interest rate is designed to give the borrower credit for those balances; therefore, in the event the balances are not maintained, the stated rate of interest on the loan will be increased proportionately to account for the deficiency in the required balance and such deficiency shall not be considered an event of default on the loan.[311] Although a clause to this effect may forestall any allegations of antitrust violations, the lender should still be cognizant of usury limitations. If, for example, the interest rate is already at the maximum allowed by law, the loan on its face would appear to be usurious since it states that credit is being given for the compensating balances; furthermore, if a deficiency occurs and the rate is raised, then the usury limitations would certainly be violated.

The same considerations relevant to compensating balances also apply to any other requirements imposed by the bank as a condition of lending money, and lenders should include such provisions only after careful evaluation. For example, in *Sundance Land Corp. v. Community First Federal Savings & Loan*

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[310] *Term Loan Handbook*, *supra* note 271, at 62; R. NASSBERG, *supra* note 297, at 12; Lobenfeld, *supra* note 280, at 329-44.

[311] R. NASSBERG, *supra* note 297, at 12.

Association,[312] the bank agreed to loan $8 million to the borrower for improvements to an orchard but conditioned the loan upon the construction of two motels upon the property in question.[313] The Ninth Circuit held that the bank's requirement that the motels be erected constituted a violation of the tying provisions of the Home Owners' Loan Act.[314] On the other hand, the Fifth Circuit affirmed the dismissal of the plaintiff's complaint alleging violations of the Sherman Act[315] and Clayton Act[316] in *Red Fox Industries, Inc. v. Federal Savings & Loan Insurance Corp.*[317] The basis for the plaintiff's suit in *Red Fox* was the bank's requirement that, in order to borrow $1 million, the customer must borrow an additional $2.45 million to purchase two buildings controlled by the bank.[318]

2. Control Problems: Management Change Clauses and Stock Pledges

The case of *State National Bank v. Farah Manufacturing Co.*[319] is indicative of the type of problems that can arise where the lender retains the right to veto changes in the borrower's management. Although loan documents commonly include such veto provisions or grant the lender the right to require changes in management upon the occurrence of certain events, the lender should exercise such rights with extreme caution. "Lender interference with management transgresses the fundamental principle that a corporation is to be managed by, or under the direction of, its board of directors."[320] As a general rule, the lender is much better advised to tell its borrower to take what action it desires to take and that the lender will then make its decision as to what action it should take in accordance with the terms of the

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[312] 840 F.2d 653 (9th Cir. 1988).

[313] *Sundance Land Corp.*, 840 F.2d at 656.

[314] *Id.* at 660.

[315] 15 U.S.C. §§ 1-7 (1988).

[316] *Id.* §§ 26-27.

[317] 832 F.2d 340 (5th Cir. 1987).

[318] *Red Fox Indus., Inc.*, 832 F.2d at 341.

[319] 678 S.W.2d 661 (Tex. 1984); *see also* Williamson & Tanner, *supra* note 4, at 9-14 (discussion of K.M.C. Co. v. Irving Trust Co.).

[320] MacKinnon & Eisler, *supra* note 299, at 741.

loan documents.

Without undermining the caution just recommended, management change clauses can effectively serve a purpose if used appropriately. In *Camelot Ltd. v. Union Mutual Life Insurance Co.*,[321] the financier advanced $3 million, secured by a deed of trust and security agreement.[322] Any sale, assignment or transfer of the premises securing the debt, as well as any change in management, without the prior written consent of the financier, constituted an event of default under the terms of the deed of trust. Furthermore, the deed of trust expressly provided that the current management was a material consideration in making the loan and that no change in management would be allowed for at least five years from the date of the loan.[323] About a year after the loan was made and without the financier's advance consent, the borrower leased the premises with an option to purchase. The financier accelerated the loan, including accrued interest and a prepayment penalty of $299,000.[324] The Arizona Court of Appeals upheld the financier's actions. The court emphasized that the loan documents expressly stated that continuation of present management was a critical factor in its decision to loan money. The borrower had knowingly agreed to this provision and was therefore bound by it.[325]

Despite successes such as *Camelot*, provisions that can result in the lender's exercising actual control over the borrower, or even provisions which create the appearance that the lender can exercise control over the borrower, should be approached with caution. Accordingly, the lender should be wary of serving upon the board of directors of its borrowers and of accepting a pledge of stock as security for the loan. Pledges of stock are potential problems, not only under general corporate principles (and fiduciary principles), but also under the Bank Holding Company Tax Act,[326] the National Bank Act,[327] and bankruptcy

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[321] 154 Ariz. 330, 742 P.2d 831 (1987).
[322] *Camelot Ltd.*, 742 P.2d at 831.
[323] *Id.* at 832.
[324] *Id.* at 831.
[325] *Id.*
[326] 26 U.S.C. §§ 311, 1101-03, 6151, 6158 (1988).
[327] 12 U.S.C. § 24 (1988).

laws.[328] One leading author recommends that a lender with voting equity securities establish a voting trust to divest itself of legal ownership.[329]

3. Material Adverse Change Clauses

Many loan documents include a material adverse change clause which, when violated, triggers certain rights and remedies of the lender. Essentially, this clause says that the borrower shall take no action which will materially and adversely affect the lender's rights. The primary problem with this type of clause is that it is inherently ambiguous and will inevitably lead to a dispute between the lender and the borrower regarding whether a particular change is in fact material and adverse.

If a material adverse change clause is included in a loan document, the lender should attempt to set forth in as much detail as practicable the types of changes that will be considered, the circumstances that constitute a material adverse change, how that change is measured, and the date upon which changes will be measured. Typically, such clauses will be tied to certain financial tests.[330] One author has suggested that material adverse change clauses are unnecessary where the loan documents include extensive representations, warranties, and covenants. However, even that author agrees that inclusion of a material adverse change clause as a condition to *future advances* serves a useful purpose in that it can "qualify the lender's commitment without threatening the entire outstanding loan."[331]

4. Compliance with Wage and Tax Laws

The Fair Labor Standards Act,[332] which specifies minimum wage and overtime provisions, includes certain sections which forbid any person from introducing into interstate commerce any goods which were produced in violation of the act. Lenders who foreclose on inventory produced in violation of this act are

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[328] 11 U.S.C § 547 (1988).

[329] MacKinnon & Eisler, *supra* note 299, at 763-64.

[330] *See supra* notes 295-97 and accompanying text (discussion of financial tests).

[331] Hilson, *supra* note 100, at 773.

[332] 29 U.S.C. §§ 201-19 (1988).

now deemed to fall within the category of "any person" and are no longer allowed to realize on the collateral until the wage violations are cured.[333] For example, in *Citicorp Industrial Credit, Inc. v. Brock*,[334] Citicorp loaned a substantial sum of money to a hosier and clothing manufacturer in Memphis, Tennessee, secured by inventory, accounts receivable, and other assets.[335] When the borrower defaulted on the loan, Citicorp took possession of the inventory.[336] Unfortunately, the mill workers had not been paid for the last two weeks of employment.[337] The United States Supreme Court ruled that the goods in question could not be sold until the wage violations were cured.[338] The Court concluded that applying the provisions of the Fair Labor Standards Act to secured lenders would further the goals of the act by "eliminating the competitive advantage enjoyed by goods produced under substandard labor conditions."[339] The Court noted that secured creditors are often in the best position to insist on compliance with the Act since they usually monitor the borrower's operations closely.[340]

In addition to liability under the Fair Labor Standards Act, a lender may find itself liable under the Internal Revenue Code for unpaid withholding taxes of the borrower.[341] The degree of

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[333] *See* Citicorp Indus. Credit, Inc. v. Brock, 107 S. Ct. 2694 (1987) (discussion of lenders as "any person").

[334] 107 S. Ct. 2694 (1987).

[335] *Citicorp Indus. Credit, Inc.*, 107 S. Ct. at 2696.

[336] *Id.* at 2697.

[337] *Id.*

[338] *Id.* at 2702.

[339] *Id.*

[340] *Id.* at 2701.

[341] I.R.C. § 3505 (1989). The statute, which creates the potential for liability provides:

> (a) Direct payment by third parties.
>
> For purposes of sections 3102, 3202, 3402, and 3403, if a lender, surety, or other person, who is not an employer under such sections with respect to an employee or group of employees, pays wages directly to such an employee or group of employees, employed by one or more employers, or to an agent on behalf of such employee or employees, such lender, surety, or other person shall be liable in his own person and estate to the United States in a sum equal to the taxes (together with interest) required to be deducted and withheld from such wages by such employer.
>
> (b) Personal liability where funds are supplied.

liability varies according to the extent of participation by the lender.[342] For example, a lender who directly pays the borrower's employees must withhold the appropriate taxes and pay such taxes to the government.[343] If the lender fails to comply, it is liable for the full amount of the taxes.[344] On the other hand, a lender who advances money for payment of wages is liable only up to twenty-five percent of the amount of advanced funds, even though the lender knows the borrower does not intend to pay the taxes.[345] Although the distinction between direct payment of wages and funding of wages seems clear, in fact it is not. If the lender cannot be held fully liable under section 3505(a) of the Internal Revenue Code, the Internal Revenue Service will make every effort to impose full liability under section 6672(a).[346] The

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> If a lender, surety, or other person supplies funds to or for the account of an employer for the specific purpose of paying wages of the employees of such employer, with actual notice or knowledge (within the meaning of section 6323(i)(1) that such employer does not intend to or will not be able to make timely payment or deposit of the amounts of tax required by this subtitle to be deducted and withheld by such employer from such wages, such lender, surety, or other person shall be liable in his own person and estate to the United States in a sum equal to the taxes (together with interest) which are not paid over to the United States by such employer with respect to such wages. However, the liability of such lender, surety, or other person shall be limited to an amount equal to 25 percent of the amount so supplied to or for the account of such employer for such purpose.
>
> (c) Effect of payment.
>
> Any amounts paid to the United States pursuant to this section shall be credited against the liability of the employer.

Id.

[342] *Id.*; *see supra* note 341 (setting forth full text of sections 3505(a) and (b) creating liability for withholding).

[343] I.R.C. § 3505(a) (1989).

[344] *Id.*

[345] I.R.C. § 3505(b) (1989); *see supra* note 341 (setting forth full text of section 3505(b)).

[346] I.R.C. § 6672(a) (1989). The statute provides, in pertinent part:

> Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over. No penalty shall be imposed under section 6653 for any offense to which this section is applicable.

Id.

case of *United States v. North Side Deposit Bank*[347] is illustrative. The government argued that the lender's honoring of payroll checks on an overdrawn account constituted a direct payment of wages under Internal Revenue Code section 3505, for which the lender could be held fully liable for unpaid withholding taxes.[348] The court rejected the government's theory, noting that the lender had no control over the check writing process, nor did it even know the dollar amount of payroll.[349] Nevertheless, the court concluded that the lender was a responsible person under section 6672(a) and therefore could be held liable in full for taxes during a limited period of time.[350] In imposing liability, the court considered that the lender managed and collected the borrower's receivables.[351] The lender also received a property report which showed that the government had filed tax liens. Moreover, the lender converted overdrafts to a loan which, combined with the tax liens, should have put the bank on notice that the borrower could not pay its taxes. Ultimately, the bank assumed control over the borrower.[352]

Until recently, the circuits differed over whether the government had to give notice of a tax assessment to the lender.[353] In *Jersey Shore State Bank v. United States*,[354] the Supreme Court resolved that conflict, holding that the government had no

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[347] 569 F. Supp. 948 (D.C. Penn. 1983).

[348] *North Side Deposit Bank*, 569 F. Supp. at 962.

[349] *Id. But see* United States v. Park Cities Bank & Trust Co., 481 F.2d 738, 741 (5th Cir. 1973)(where lender honored overdrafts on customer's general accounts when such amounts were transferred to special account designated as payroll and where lender made some loans which were applied to payroll account, lender could be held liable for unpaid taxes on theory it supplied payroll funds).

[350] *Northside Deposit Bank*, 569 F. Supp. at 960-61.

[351] *Id.* at 960.

[352] *Id.*

[353] The idea that notice was required originated from 26 U.S.C. § 6303(a), which states:

> Where it is not otherwise provided by this title, the Secretary shall, as soon as practicable, and within 60 days, after the making of an assessment of a tax pursuant to section 6203, give notice to each person liable for the unpaid tax, stating the amount and demanding payment thereof. Such notice shall be left at the dwelling or usual place of business of such person, or shall be sent by mail to such person's last known address.

Id.

[354] 479 U.S. 442 (1987).

obligation to provide the lender with notice of a tax assessment against the borrower, at least where the lender's liability arose pursuant to section 3505(b).[355] Among other reasons, the court opined that the lender must already have actual notice or knowledge before liability could be imposed under section 3505.[356] Accordingly, the lender could not be prejudiced in any respect by lack of formal notice from the government. Furthermore, the Court concluded that the lender could protect itself from such potential liability by charging higher fees and demanding adequate security.[357]

As a result of potential wage and tax problems, lenders may desire to include covenants that the borrower will comply with all federal and state wage and tax requirements and that the borrower will furnish the lender with satisfactory proof of compliance on an ongoing basis. Although a provision of this kind may protect the lender from having to cure its borrower's violations, these provisions are subject to allegations of control by the lender and could conceivably lead to greater liability on the part of the lender than if the lender had merely cured such violations itself. Perhaps a satisfactory method to avoid this problem is to include a provision that, if the borrower fails to comply with wage and tax requirements, the lender may promptly cure such violations and increase the principal amount of the loan balance by the amount paid out to cure violations.

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[355] *Jersey Shore State Bank*, 479 U.S. at 446-47.

[356] For a discussion of the *Jersey State Bank* case and the Court's reasoning, see Cozort, *Lender Liability for Borrower's Withholding Tax*, 20 U.C.C. L.J. 354, 362 (1988); *see also* Burke, *Emerging Theories of Lender Liability*, I ALI-ABA 397, 462-63 (1987)(discussion of liability for withholding taxes); Doernberg, *The Case Against Withholding*, 61 TEX. L. REV. 595, 599-603 (1982)(same); Feldman, *Taxation—Exercise of Only 'Significant' Control over Debtor's Operations Subjects Lender to 100 Percent Withholding Tax Penalty*, 43 FORDHAM L. REV. 898, 898-902 (1975)(same); Makel & Chadwick, *Lender Liability for a Borrower's Unpaid Payroll Taxes*, 43 BUS. LAW. 507, 520-24 (1988)(same); Thannhauser, Riemer & Friedman, *Lender's Liability for Unpaid Withholding Taxes of Borrower-Employer—IRC Sections 3505 and 6672*, 80 COM. L.J. 137 (1975)(same); Winston, *Lender's Liability for Borrower's Unpaid Employment Taxes*, TEX. BUS. J. 1253, 1254-56 (Nov. 1983)(same).

[357] *Jersey Shore State Bank*, 479 U.S. at 447-48.

E. Events of Default

Events of default are occurrences which give rise to the lender's right to exercise its remedies as provided for in the loan documents.[358] Typical events of default include failure to pay the principal and interest under the loan as due, breach of any representations and/or warranties in the loan documents, breach of any covenants and bankruptcy. Defining special events of default may be necessary to protect the lender's interest, including events such as the death of a key officer or the breach or discontinuance of a key contract.[359]

With regard to events of default, the loan documents should:

(1) Clearly define what constitutes an event of default;

(2) Specify whether the borrower has a grace period within which to cure the default;

(3) If a grace period is allowed, specify:

(a) the number of days the borrower is allowed to cure and that such days run consecutively until cure is effectuated;

(b) whether the days to cure are calendar days or business days;

(c) when the grace period begins to run;[360]

(d) the particular events of default that can be cured and those that cannot be cured;[361] and

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[358] R. TIGHE, *supra* note 297, ¶ 7.01. Based upon the terms of the particular loan agreement, an act may automatically trigger the lender's rights without any action on the part of the lender or it might give the lender discretion to exercise its option to pursue its remedies. The two most common remedies are the termination of the lender's obligation to make any future advances under the loan agreement and the acceleration of the loan. *Id.*

[359] *Id.*; *see also* W. HILLMAN, *supra* note 206, at 57 (discussing various specific events of default and related contractual provisions).

[360] For example, does the grace period automatically begin to run from the date of the occurrence which constitutes an event of default, irrespective of whether the bank has knowledge of the occurrence? Or must the bank give the customer notice that an occurrence is considered to be an event of default and that the grace period is running? If notice is required, is the notice effective upon mailing or upon receipt by the customer?

[361] One author suggests that a grace period should not be granted for a breach of representation since the borrower cannot retroactively cure such a breach. R. TIGHE, *supra* note 297, ¶ 7.01[2]. However, such a "non-curable" breach may not be appropriate in every situation. For example, assume that the borrower provided the lender with fi-

(4) State the remedies available to the lender upon the occurrence of an event of default.

The two remedies most often included by lenders are the termination of all commitments to loan additional funds and the requirement that all outstanding loans be immediately repaid.[362] An indemnification provision binding the debtor to pay all costs and expenses, including but not limited to, attorney's fees, court or arbitration costs, and other costs, incurred as a result of the debtor's default should also be included.

F. Prepayment Provisions[363]

1. The Borrower's Right to Prepay

Borrowers will often request the ability to prepay a loan without any penalty. Prepayment may range anywhere between payment in full of the outstanding balance to a negligible amount in addition to the normal installment. To avoid any confusion regarding the borrower's obligation where a partial prepayment is made, the loan document should clearly set forth what happens upon prepayment. For example, assume the monthly payment is $1,000, due the first of each month. If on January 1 the borrower makes a $3,000 payment, does this mean that no payment is required again until April 1? If the lender

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nancial statements, upon which the lender relied in deciding to extend credit; the borrower represented that those financial statements were true and correct; the borrower included in the financial statements $100,000 cash which allegedly was in a particular account on that date; however, the borrower knew the money was not in the account on that date, but that it would be deposited into the account the following day and the money was in fact so deposited. Six months later the bank discovers the "misrepresentation." If the borrower is not in default under other terms of the loan on the date the misrepresentation is discovered, some courts might say the misrepresentation was not material and/or that the bank acted in bad faith by declaring the loan in default based solely on that misrepresentation. The bank has not been damaged by the misrepresentation in any way since the misrepresentation was in fact cured by the depositing of the money the next day. If, on the other hand, the borrower has failed to pay in accordance with the terms of the loan agreement, or has committed other acts of default, then the bank may assert its rights and include, *in addition to* the other events of default, the misrepresentation in the financial statements.

[362] *See supra* notes 157-63 and accompanying text (discussing cases dealing with acceleration clauses and insecurity provisions).

[363] *See supra* notes 31-34 and accompanying text (discussing cases dealing with prepayment disputes).

expects payments to continue on an uninterrupted basis, the agreement should clearly set this out by stating that prepayments shall be applied to installments in remote or inverse order of maturity.[364]

2. The Lender's Right—Provisions Requiring Mandatory Prepayment or Acceleration of the Loan

Events of default may result in the borrower's being required to repay in full all debts outstanding with the lender. This requirement to repay may be automatic and mandatory, or it may be at the discretion of the lender. Similarly, some loan documents include a provision that accelerates the loan balance or allows the lender to foreclose on collateral if the lender deems itself insecure. Insecurity provisions are inherently ambiguous. It is much safer to tie the acceleration provisions to objectively determinable events which affect the borrower's ability to repay.

Despite an unambiguous contractual right to demand payment in full, some courts apply concepts of good faith or materiality to achieve what the court considers a fair result. In those instances, the effect is that the lender is restrained from enforcing the documents as written. Mississippi decisions favor the parties' rights to take action expressly authorized by the contract. Therefore, lenders should not be hesitant to include such provisions, nor to enforce their rights and remedies when appropriate under the terms of the loan documents.[365]

G. Special Provisions

1. Borrower's Acknowledgment of Sophistication

For many years, acknowledgments of sophistication have been required of investors purchasing shares of stock offered for sale pursuant to exemptions from registration under the Securities Act of 1933.[366] That same philosophy is being applied by

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[364] R. TIGHE, *supra* note 297, at ¶ 1.06[4].

[365] *See supra* notes 157-63 and accompanying text (discussing cases dealing with acceleration clauses and insecurity provisions); *see also* Williamson & Tanner, *supra* note 4, at 2-5 (same; also discussing Mississippi cases).

[366] 15 U.S.C § 77 (1988).

lenders seeking protection from allegations of overreaching, coercion and breach of fiduciary duties.

In the lending context, the acknowledgment should accomplish the following:

> Counsel should state that the borrower was told that the borrower was under no compulsion to execute the waiver and release, that the borrower exercised independent judgment to act and that it acted in its free will, without duress, coercion or compulsion. (Express references to any jury trial waiver or provision for arbitration of disputes should also be included.) The acknowledgment should clearly express that [borrower's] counsel explained that the purpose of the waiver and release was to estop and foreclose the borrower from instituting any action or refuting any obligations or agreement on any "victimization" theory.[367]

As an added protection, a provision should be included which requires the borrower to immediately notify the lender if the borrower contends that it has been injured by any action of the lender and that failure to so notify the lender constitutes a waiver.[368]

2. Integration/Merger Clauses

All agreements should include what is referred to as a merger clause. This clause states that the document in question constitutes the entire agreement of the parties and that there are no other oral agreements or promises between the parties. This clause should also provide that all prior negotiations, whether written or oral, are integrated into and superceded by this one document, and that such prior negotiations, communications and drafts, are of no evidentiary value and cannot be introduced into any proceeding. Absent fraud or mutual mistake, provisions to this effect should protect the lender from allegations by the borrower that there were side agreements to the particular loan documents, such as a side agreement that the

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[367] MacKinnon & Eisler, *supra* note 299, at 754.

[368] *Id.*

lender would extend the loan or not foreclose on the collateral.[369]

3. Conflicts of Law and Forum Provisions: Federal Court v. State Court

It is a good idea to include a conflicts of law provision in every loan document. This clause specifies which state law governs the terms of the document. As long as the specified state law is reasonably related to the loan, Mississippi courts will enforce such a provision.[370]

Similarly, lenders may prefer to litigate disputes in certain forums. Accordingly, a provision may be included in the loan documents which requires all disputes to be litigated in a certain forum, such as a state court instead of a federal court.[371]

4. Jury Waivers and Alternative Dispute Resolution

Most of the large punitive damages awards against lenders have been the result of jury trials. Therefore, lenders sometimes attempt to avoid juries, either by requiring arbitration of disputes or other forms of alternative dispute resolution, or by express, advance waiver of the right to a jury trial.

Lenders may include a provision in loan documents which says that the right to trial by jury is waived. For purposes of achieving a balance of both the lender's rights and the borrower's rights, the loan documents should make it clear that *both* parties—that is, the lender and the borrower—are giving up their right to a jury trial. This makes the provision seem fair and is less likely to result in allegations of overreaching, coercion, and duress against the lender. The lender should keep in mind that, in the event the jury waiver provision is declared unenforceable, such provisions may be brought to the jury's atten-

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[369] For an interesting discussion of the problems faced in California as a result of the liberal view toward admission of parol evidence, see Engel, *The Cloud Cast Over Contracts in California Continues to Grow*, 2 LENDER LIABILITY L. REP. 5, 5-7 (H. Chaitman ed. Aug. 1988).

[370] *See supra* note 293 (discussing when Mississippi courts will uphold conflicts of law provisions and providing sample language for such provisions).

[371] *See, e.g.*, Paul v. International Precious Metals Corp., 613 F. Supp. 174 (S.D. Miss. 1985) (court upheld venue selection clause and choice of forum clause).

tion to show an attempt by the lender to deprive the borrower of his rights.

The Mississippi Constitution Art. III, section 31 absolutely guarantees a right to trial by jury.[372] Mississippi Rule of Civil Procedure 38(b) allows parties to an action to waive their rights to a jury trial. However, the rule further provides that all waivers of the jury right must be made "by filing with the court a specific, written stipulation that the right has been waived and requesting that the action be tried by the court."[373] The rule even goes on to say that despite the waiver of the jury right the judge may in his discretion nevertheless require a jury trial.[374] Although Mississippi cases generally support the proposition that the right of jury trial may be waived by the parties,[375] it is unclear whether a *contractual* waiver would be upheld.[376]

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[372] MISS. CONST. art. III, § 31. The provision states that "[t]he right of trial by jury shall remain inviolate. . . ." *Id.*

[373] MISS. R. CIV. P. 38(b)(1988).

[374] *Id.* The Federal Rules of Civil Procedure have a similar provision. FED. R. CIV. P. 39(b). Rule 39(b) states:

> "[I]ssues not demanded for trial by jury as provided in Rule 38 shall be tried by the court; but, notwithstanding the failure of a party to demand a jury in an action in which such a demand might have been made of right, the court in its discretion upon motion may order a trial by a jury of any or all issues.

Id. See generally, Annotation, *Discretion of District Court Under Rule 39(b) of Federal Rules of Civil Procedure, Authorizing It to Order Jury Trial Notwithstanding Party's Failure to Make Seasonable Demand for Jury*, 6 A.L.R. FED. 217, 217-65 (1971)(discussion of cases on judge's discretion).

[375] *See, e.g.*, Isaac v. McMorris, 461 So. 2d 714, 715 (Miss. 1984) ("[T]he right of jury trial may be waived by the parties."). In City of Jackson v. Clark, 152 Miss. 731, 118 So. 350 (1928), the Mississippi Supreme Court addressed limitations on the right to trial by jury in light of the Mississippi constitutional guarantee of such right. The Court opined:

> This constitutional provision must be interpreted to mean that it shall never be destroyed, annulled, nor so hampered or restricted by legislation as to make the provision a nullity. It does not mean that it shall be totally immune from all reasonable regulations. Any reasonable regulation, free from arbitrary and unreasonable provisions regarding the enjoyment of the right, will not be a denial or impairment thereof.

Id., 118 So. at 351.

[376] *See generally* Annotation, *Authority of State Court to Order Jury Trial in Civil Case Where Jury Has Been Waived or Not Demanded by Parties*, 9. A.L.R. 4th 1041 (1981) (discussing case law of jurisdictions that allow jury trial after express waiver). For other related articles related to jury trial waiver, see Annotation, *Sufficiency of Waiver of Full Jury*, 93 A.L.R. 2d 410 (1964); Annotation, *Withdrawal or Disregard of Waiver of Jury Trial in Civil Action*, 64 A.L.R. 2d 506 (1959).

Although the enforceability of a contractual jury waiver provision is uncertain in Mississippi, other states have enforced such a provision.[377] However, even in those states the courts strictly construe the jury waiver clause. For example, in *Standard Wire & Cable Co. v. Ameritrust Corp.*,[378] a bankrupt company and two guarantors for the company sued the lender, asserting various theories of lender liability.[379] The signed guaranty included a provision waiving any right to a trial by jury.[380]

The guarantors argued that the jury waiver clause was unenforceable on the grounds that it was in very small print on a printed form, as a part of a lengthy paragraph. The court rejected the guarantors' arguments, finding instead that the waiver had been agreed to knowingly, voluntarily and intentionally. In so ruling, the court considered the fact that the guarantors were represented by counsel during the negotiation of the contractual terms.[381]

The court refused, however, to enforce the jury waiver provision against the company. No similar provision was included in the loan agreement itself. Therefore, applying the jury waiver provision strictly, the court ruled that the claims and counterclaims involving the guarantors would be tried before the court, whereas the claims and counterclaims involving the company would be tried before a jury.[382]

Lenders should be careful to avoid making any oral representations that vary the express language of a contractual jury waiver provision. In *K.M.C. Co. v. Irving Trust Co.*,[383] the lender told K.M.C.'s president that, absent fraud, the jury waiver

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[377] *See generally* Annotation, *Validity and Effect of Contractual Waiver of Trial by Jury*, 73 A.L.R. 2d 1332 (1960) (discussing efficacy of waivers of jury trials by contract).

[378] 697 F. Supp. 368 (D.C. Cal. 1988).

[379] *Standard Wire & Cable Co.*, 697 F. Supp. at 371. The theories of liability included fraudulent misrepresentation, refusal to comply with an oral side agreement, bad faith, and intentional and negligent infliction of emotional distress. *Id.*

[380] *Id.* at 375.

[381] *Id*; *accord*, James Talcott, Inc. v. Wilson Hosiery Co., 32 A.D.2d 524, 525-26, 299 N.Y.S.2d 460, 461-62 (1969) (jury waiver provision upheld where there was no claim of deceit and provision was in same type as every other provision in documents).

[382] *Standard Wire & Cable Co.*, 697 F. Supp. at 375.

[383] 757 F.2d 752 (6th Cir. 1985).

clause in the financing agreement would not be enforced.[384] The United States Court of Appeals for the Sixth Circuit upheld the trial court's refusal to enforce the jury waiver provision.[385]

As an alternative to resolution of disputes in court and as another means of avoiding juries, the lender may desire to include a provision requiring arbitration of all disputes. If the transaction falls within the scope of the Federal Arbitration Act[386] or the Mississippi Construction Arbitration Act,[387] a mandatory arbitration provision is enforceable. Of course, *after* a dispute arises, the parties can mutually agree to arbitration of the dispute, and such an agreement is generally enforceable even if it does not fall within the foregoing statutes.

Arbitration has advantages and disadvantages which should be carefully considered before a lender decides to include an arbitration provision in a contract or, in the absence of such a provision, before agreeing to arbitration after a dispute arises. The overriding advantages of arbitration are that it is generally less expensive and that it results in resolution of the dispute more quickly. Additionally, the arbitrators generally have more expertise in the particular area of dispute than the general public summoned for jury duty. Finally, arbitration proceedings usually retain an element of privacy.

Despite these long-standing advantages of arbitration, the real motivation behind arbitration in most lender liability suits is avoidance of juries that have been and may continue to be inclined to award large damages.[388] However, arbitration should not be considered a shield to lender liability, although arbitrators probably are less likely to be emotionally moved to award damages to punish a lender. In at least two cases, lenders have endured substantial adverse judgments at the hands of arbitrators.

In *Cass Federal Savings & Loan Association v. Western*

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[384] *K.M.C. Co.*, 757 F.2d at 755.

[385] *Id.* at 758.

[386] 9 U.S.C. § 2 (1987).

[387] Miss. Code Ann. § 11-15-101 (Supp. 1987).

[388] As a result of the denial of a jury trial, arbitration proceedings have been challenged as a constitutional violation. For a discussion of such cases, see Annotation, *Constitutionality of Arbitration Statutes*, 55 A.L.R. 2d 432 (1957).

Gulf Savings & Loan Association,[389] one lender (Cass) sought rescission of its purchase of participations in two loans from another lender (Western). The arbitrator concluded that Western made material misrepresentations which induced Cass to participate in the loans and that Western had breached a fiduciary obligation it owed to Cass stemming from special circumstances related to an employee.[390] The arbitrator ordered Western to repay all sums paid by Cass, together with lost interest at the rate of 8.9%, and all attorneys' fees, costs and expenses of arbitration.[391]

Similarly, in *Seis-Port Exploration, Inc. v. Capital Federal Savings & Loan Association*,[392] the arbitrators awarded Seis-Port $2.77 million in damages, plus interest, resulting in a total award of $3.2 million. Capital Federal sent a series of letters to Seis-Port explaining the terms under which it would extend a total of $5 million credit, for which Seis-Port paid $5,000 to keep the commitment open. Capital Federal contended the obligation to loan money was conditioned upon obtaining a 40% loan participant. When the only promising loan participant refused to participate in the loan, Capital Federal refused to lend the money, and Seis-Port ultimately went out of business. In awarding damages to Seis-Port, the arbitrators concluded that Capital Federal's letters constituted a loan contract.[393]

In addition to the substantial adverse judgments the above noted lenders suffered, these cases demonstrate some of the potential drawbacks to arbitration of a given case. First, in the absence of extreme and unusual circumstances, the arbitrators' decision is final. There are no appeals. Also, the usual rules of evidence do not apply in arbitration proceedings. Accordingly, evidence that might be excluded from a trial may very likely be introduced in an arbitration. Finally, there is no formal discovery process in arbitration unless the parties voluntarily agree or

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[389] No. 71-199-1061-88-D (Feb. 24, 1989) (Gary, Arb.), *discussed in* 2 LENDER LIABILITY L. REP. 2, 2-5 (June 1989).

[390] *Cass Fed. Sav. & Loan Ass'n*, 2 LENDER LIABILITY L. REP. 2, 4.

[391] *Id.*

[392] For a discussion of this arbitration proceeding, see Pitts, *Arbitrating Lender Liability Claims*, 105 BANKING L.J. 227, 236 (1988).

[393] *Id.*

the arbitration provision specifically allows discovery.

There are still other special concerns that should be assessed when considering arbitration.[394] For example, an agreement that includes an arbitration provision may not be enticing to another lender. This could substantially hamper the ability to sell the loan in the secondary market. To offset this potential problem, one author suggests a self-destructing clause. This clause provides that a buyer of a loan must affirmatively elect to retain the arbitration provision within a specified period of time or it is automatically terminated.[395] A significant risk with an arbitration provision is the preclusion from exercising other contractual rights, such as foreclosure by virtue of a power of sale clause, without waiving rights to arbitration. Any arbitration provision should be carefully drafted so that the right to arbitration will remain viable, despite the exercise of other contractual rights.[396]

5. Exculpation Clauses

An exculpation clause is designed to protect the lender from liability for ordinary negligence, such as failure to exercise reasonable care. When the lender's conduct rises to the level of intentional or reckless conduct, however, such a clause may not be enforceable on grounds that it is against public policy.

Lenders should also consider inclusion of a release clause which automatically bars suit upon repayment of the loan. In *Taggart & Taggart Seed, Inc. v. First Tennessee Bank National Association*,[397] the loan agreement included a release clause which provided that "upon full payment and satisfaction of the loan and the interest thereon, as provided in Paragraph 3 hereof, the parties shall thereupon automatically each be fully, finally, and forever released and discharged from any further claim, lia-

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[394] Butler, *Arbitration: Advantages, Concerns for Lenders*, 1 LENDER LIABILITY NEWS 1, 1-2 (July 13, 1988) [hereinafter Butler, *Arbitration: Advantages*]. For a sample arbitration clause and a discussion of the various provisions, see Butler, *'Model' Arbitration Clause for Financial Institutions*, 1 LENDER LIABILITY NEWS 1-2 (Aug. 10, 1988).

[395] Butler, *Arbitration: Advantages*, *supra* note 394, at 2.

[396] *Id.*

[397] 684 F. Supp. 230 (E.D. Ark. 1988).

bility or obligation in connection with the loan."[398]

The court ruled that the release was enforceable and that plaintiffs' claims were therefore barred since the loan had been repaid.[399] This type provision is common in the construction context, whereby the contract provides that acceptance of final payment on the project constitutes a release and waiver of any and all claims.

Another form of exculpation or nonrecourse clause is one which is designed to protect officers, directors and partners from liability for any deficiency after foreclosure on the collateral. This clause essentially says that the lender will look solely to the collateral for satisfaction of the debt. Even where a clause of this kind is included, the lender usually includes a list of exceptions that negate the effectiveness of the exculpation clause.

6. Limitations on the Borrower's Remedies

One clause that may reduce the lender's exposure to lawsuits is a form of contractual notice requirement. One author suggests including a provision which imposes an obligation on the borrower to notify the lender in writing within a certain number of days if the lender takes any act or fails to act and the borrower contends it is injured as a result.[400] In the event the borrower fails to notify the lender within the stated time, all claims by the borrower arising from the lender's acts or omissions are barred. The idea is to give the lender time to take corrective action on a timely basis where appropriate.

Another method by which the lender can reduce its exposure is to limit the remedies available to the borrower upon any breach by the lender. Two limitations are common: (1) liquidated damages and (2) specific performance.[401]

Liquidated damages set out in advance the dollar amount the borrower may recover in the event the lender defaults on its

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[398] *Taggart*, 684 at 231.

[399] *Id.* at 234.

[400] Poscover, *Avoidance Techniques: Protective Clauses in Loan Documents — Drafting Suggestions*, 2 LENDER LIABILITY L. REP. 6, 6-7 (July 1988).

[401] MacKinnon & Eisler, *supra* note 299, at 744-45.

obligations.[402] Specific performance allows the borrower to request that a court command the lender to do the act which the lender has refused to do.

7. The Unwritten Provision: Course of Dealing

As discussed in the introduction to this article, loan documentation is only one factor in a lender liability action; equally, if not more, important is the conduct of the lender. As such, there is what the authors refer to as "the unwritten provision" in all loan documents—that is, the parties' course of dealing. This unwritten provision is a reminder to lenders that their conduct is most likely to come into issue in a lender liability action.

"Course of dealing" is a U.C.C. term which refers to the parties' conduct with respect to a transaction.[403] A simple example in the lending context will explain this term. Assume that the borrower must make an installment payment on the first day of every month. However, the borrower has routinely paid on the twentieth day of each month. Although the late payments were events of default under the terms of the loan documents and the lender could have demanded repayment in full, the lender al-

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[402] Poscover, *supra* note 397, at 7. The author provides a sample liquidated damages abuse, as follows:

> If the Bank shall be in breach of the Bank's obligations under this Agreement by reason of failure to make an advance as the Bank is required to do under the terms hereof, the Borrower's sole remedies on account thereof shall be:
>
> (a) To compel the Bank to make the advance which is determined wrongfully to have been withheld (upon the making of which, the same shall be treated as any other advance pursuant to the terms of this Agreement); and
>
> (b) To recover liquidated damages on account of such breach, computed as hereinafter provided, in recognition of the fact that the damages which the Borrower might incur are uncertain and speculative.
>
> Liquidated damages to which the Borrower shall be entitled shall be equal to two times the interest on the wrongfully withheld advance at the rate payable by the Borrower under the terms of this Agreement for advances which the Borrower is to receive hereunder, computed from the date when such wrongfully withheld advance should have been made to the date when the same is, in fact, made.
>
> In any event, the Bank shall never be liable to the Borrower for consequential damages, whatever the nature of a breach by the Bank in the obligations of the Bank hereunder.

Id.

[403] U.C.C. § 1-205(1)(1987).

ways accepted the late payments. The lender has effectively established a course of dealing by routinely accepting the late payments. Courts have almost uniformly held that a lender may not habitually accept late payments, then attempt to declare default because a payment is late without first giving reasonable notice to the borrower that late payments will not be accepted in the future and that the borrower is required to comply strictly with the terms of the loan documents.[404]

Lenders should include anti-waiver provisions in their loan agreements requiring that all amendments be made in writing and that the waiver of one or more defaults is not a waiver of future defaults. Lenders should keep in mind, however, that courts are not in agreement regarding the enforceability of anti-waiver clauses. Some courts have held that anti-waiver provisions cannot be modified through course of performance or dealings.[405] Other courts have held that anti-waiver clauses can be modified or waived at least to the extent of obligating the lender to give advance notice of its intent to strictly enforce the parties' contract.[406]

Before exercising rights under loan documents, lenders should carefully analyze their prior treatment of the loan in question and the representations that have been made to the borrower during the course of the loan. The unwritten course of dealing may require the lender to take additional steps before exercising its express rights under the agreement.

8. Setoff

Despite common law rights to set off a debtor's deposit ac-

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[404] *See, e.g.*, Pierce v. Leasing Int'l, Inc., 142 Ga. App. 371, 235 S.E.2d 752, 754 (1977)("If [the creditor] has given the debtor the reasonable impression that late payments will be accepted or that an arrearage need not be paid immediately, then the creditor may be estopped to engage in self-help repossession until he has given notice, demanded payment or otherwise indicated to the debtor that he is considered to be in default."); Alaska Statebank v. Fairco, 674 P.2d 288, 293 (Alaska 1983)(oral statements and conduct of parties modified written agreement so that notice prior to repossession was required);.

[405] *See, e.g.*, Hale v. Ford Motor Credit Co., 374 So. 2d at 49, 853 (Ala. 1979) (enforceable); Van Bibber v. Morris, 275 Ind. 555, 419 N.C. 2d 115, 121 (1981) (same).

[406] *See, e.g.*, Westinghouse Credit Corp. v. Shelton, 645 F. 2d 869, 873 (10th Cir. 1981) (citing cases following this approach).

count against a debt owed to the bank, it is preferable to include a provision in the loan documents which expressly grants a right of setoff to the lender. The lender is a creditor in the unique position of being able to monitor the customer's financial stability by review of the customer's account activity. As such, the lender has the ability to set off prior to the time the customer's financial security becomes hopeless. Even though the lender may have the right to set off when it becomes apparent that the customer is headed for bankruptcy, the lender should consider whether to do so is in its best interest. Under the Bankruptcy Code, to the extent a setoff results in an improvement in the lender's position within ninety days prior to bankruptcy, the improvement must be returned.[407]

The bank's right of setoff is not absolute. When the bank has knowledge of a trust, special deposit, or some other type of fiduciary relationship between its depositor and a third person, the bank cannot set off such funds against the individual indebtedness of the depositor.[408] Absent special circumstances which should put the bank on notice that funds are held in trust, there is no obligation on the part of the bank to inquire whether a trust relationship exists. For example, in *Blanchard v. Peoples Bank*,[409] Mr. and Mrs. Blanchard used the proceeds from the sale of their California home to purchase a $100,000 certificate of deposit from Peoples Bank in Houston, Texas. The Blanchards' daughter, Barbara Gibson, executed the documents

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[407] Hilson, *supra* note 100, at 777-79; MacKinnon & Eisler, *supra* note 299, at 758-61.

[408] *See* Central Bank v. Butler, 517 So. 2d 507, 511 (Miss. 1987)(court held payments made for livestock which were deposited in general account of livestock exchange company were trust funds; bank improperly set off against funds and was liable for actual damages, punitive damages, and attorney's fees); Lumberton State Bank v. Fortenberry, 222 So. 2d 384, 388 (Miss. 1969)(bank improperly set off against auctioneer's account which contained proceeds from auction sales and was intended to be used to pay owners of cattle sold at auction). *But see* Deposit Guar. Nat'l Bank v. B.N. Simrall & Son, Inc., 524 So. 2d 295, 301 (Miss. 1987)(bank offset funds of cotton buyer's general business account to apply on indebtedness due bank by cotton buyer, thereby causing cotton buyer's check to farmer to be returned for insufficient funds; court held that bank properly set off funds where funds were part of general business account and contained no special designation or instructions and no indication that the funds were held in trust for the farmer).

[409] 844 F.2d 264 (5th Cir. 1988).

for the purchase of the certificate and instructed the bank to issue the certificate jointly in her name and that of her parents.[410] Soon thereafter, Gibson borrowed money from the bank, pledging the certificate as collateral. Gibson continued to borrow money, secured by the certificate, until she reached a debt of $90,000. When Gibson defaulted in her loan payments, the bank applied the certificate against the debt.[411] The Blanchards sued the bank, asserting that the bank breached its contract with the Blanchards, that the bank should have known Gibson held the money in trust for the Blanchards, and that the bank acted negligently when it failed to notify the Blanchards that Gibson had pledged the certificate as collateral for a loan.[412] The Fifth Circuit acceded to the bank's sanctions by affirming the district court's summary judgment in favor of the bank.[413] The only evidence that the bank knew the money really belonged to the Blanchards came in the form of an affidavit from an attorney who stated that a since-deceased bank employee had told him that Gibson held the money for her parents. The court ruled that such evidence was inadmissible hearsay.[414] The court rejected the Blanchards' argument that the bank should have notified them when Gibson pledged the certificate. The court ruled that to include such a notice requirement would be to add a new term to the contract which unambiguously stated that the bank could "treat as the absolute owner hereof any depositor listed on the face of the certificate."[415]

Another limitation upon a bank's right of setoff lies in what the United States Court of Appeals for the Fifth Circuit has called "mutuality of demands."[416] In other words, "[t]he right of the bank exists only where with respect to both debt and deposit the bank and the depositor are in debtor-creditor relationship."[417] Applying this principle, the bank would not have a

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[410] *Blanchard*, 844 F.2d at 265.
[411] *Id.* at 266.
[412] *Id.*
[413] *Id.* at 268.
[414] *Id.* at 267.
[415] *Id.*
[416] Kaufman v. First Nat'l Bank, 493 F.2d 1070, 1072 (5th Cir. 1974).
[417] *Id.*

right to set off a depositor's individual debt against deposits made in his capacity as a public officer, executor, or administrator.[418] Likewise, it is questionable whether a bank could set off one corporation's debts against the funds of a separate and distinct corporation.[419]

9. Participations

A bank that participates in a loan but does not act as the participating agent is exposed to liability for acts of the agent, even though the participant had no knowledge of the action. To reduce this risk, the participation/agency agreement should include a provision stating that "acts by the agent that have not been authorized by the participating lenders are not to be deemed the acts of the lenders, nor shall they give rise to vicarious liability of the lenders, whether they occur prior or subsequent to the closing of the transaction."[420] Additionally, the agreement should include an indemnification provision from the agent to the lender participants for all damages, costs and expenses, including attorney's fees, arising from the wrongful conduct of the agent. This provision should also include indemnification for settlements arising therefrom.

Conclusion

This article has addressed lender liability pitfalls associated with making, negotiating and drafting loan commitments and agreements. Loan documents are a lender's first line of defense in a lender liability case. If properly drafted, loan documents reflect the allocation of risks the parties have agreed upon. Toward that end, this article recommends that lenders modify their documentation practices to include provisions that deal explicitly with borrowers' rights and responsibilities. Including these provisions will not provide the lender with fail-safe protection, but will minimize the likelihood of a lender liability dis-

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[418] *Id.*

[419] *Central Bank*, 517 So. 2d at 511.

[420] MacKinnon & Eisler, *supra* note 299, at 755-56.

pute, since both borrower and lender will be on notice of their respective transactional risks.

CONSTITUTIONAL AND STATUTORY AUTHORITY OF THE ATTORNEY GENERAL TO PROSECUTE ACTIONS

*H.M. Ray**

Introduction

The public and many elected officials have long underestimated the extensiveness of the powers of the Mississippi Attorney General's office. In particular, confusion has surrounded the authority of the attorney general to prosecute criminal actions, including the presentation of cases to grand juries. This article attempts to dispel the myth that the office enjoys limited authority by outlining the constitutional, common law, and statutory bases for attorneys general to prosecute diverse civil and criminal actions.

Section I describes how the Mississippi Constitution endows the attorney general with all the powers the office exercised at common law. That is followed by descriptions of state and federal statutes authorizing the attorney general to handle various litigation, in Sections II and III, respectively. Section IV explains why the common law and statutes establish a foundation to support the attorney general's prosecution of criminal cases. This authority encompasses criminal investigations and appearances before grand juries, despite the infrequent exercise of these powers by attorneys general in the past. Finally, Section V asserts the attorney general's authority to oversee criminal prosecutions by virtue of the governor's role as Mississippi's chief executive.

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I. CONSTITUTIONAL POWERS

Article 6, section 173 of the Mississippi Constitution provides:

> There shall be an attorney-general elected at the same time and in the same manner as the governor is elected, whose term of office shall be four years and whose compensation shall be fixed by law. The qualifications of the attorney-general shall be the same as herein prescribed for judges of the circuit and chancery courts.[1]

Although section 173 does not list the powers of the attorney general, the Mississippi Supreme Court has held that the constitutional creation of the office of the attorney general through section 173 vests in the attorney general all the powers that the office possessed at common law.[2] This principle of law was succinctly stated in *Kennington-Saenger Theatres, Inc. v. State ex rel. District Attorney*,[3] which involved the division of authority between the attorney general and a district attorney. *Kennington-Saenger* stated:

> The duties of the Attorney General were not prescribed by the Constitution, nor did it provide that they would necessarily have to be prescribed by the legislature. They existed at common law. . . . The creation of the office of Attorney General by the Constitution vested him with these common-law duties.[4]

Specifically, the court in *Wade v. Mississippi Cooperative Extension Service*[5] declared:

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[1] MISS. CONST. art. 6, § 173.

[2] Gandy v. Reserve Life Ins. Co., 279 So. 2d 648, 649 (Miss. 1973); State *ex rel.* Patterson v. Warren, 254 Miss. 293, 306, 180 So. 2d 293, 299 (1965); Kennington-Saenger Theatres, Inc. v. State *ex rel.* Dist. Att'y, 196 Miss. 841, 866, 18 So. 2d 483, 486 (1944); Dunn Constr. Co. v. Craig, 191 Miss. 682, 711-12, 2 So. 2d 166, 174 (1941); State *ex rel.* Rice v. Steward, 184 Miss. 202, 222, 184 So. 44, 46 (1938); *see also* Wade v. Mississippi Coop. Extension Serv., 392 F. Supp. 229, 232 (N.D. Miss. 1975) (Attorney General's powers include those posssessed at common-law).

[3] *Kennington-Saenger*, 196 Miss. at 866, 18 So. 2d at 486.

[4] *Id.* at 865-66, 18 So. 2d at 486 (citing Capitol Stages v. State *ex rel.* Hewitt, 157 Miss. 576, 589, 128 So. 759, 762 (1930)); State v. Key, 93 Miss. 115, 118, 46 So. 75, 76 (1908); *accord* 7A C.J.S. *Attorney General* § 7 (1980) (stating that powers of attorneys general include those which existed at common law).

[5] 392 F. Supp. 229 (N.D. Miss. 1975).

> Though § 173 makes no delineation of the nature and scope of the Attorney General's power, the Supreme Court of Mississippi has consistently ruled that *the constitutional creation of the office, even without further statutory enactment, vested in the Attorney General all powers which that officer possessed at common-law and incorporated that common-law authority into the constitution itself.*[6]

The common-law powers of the attorney general have been described by the Mississippi Supreme Court in numerous cases.[7] In *Capitol Stages, Inc. v. State ex rel. Hewitt*,[8] the court stated:

> At common law the duties of *the attorney general*, as chief law officer of the realm were very numerous and varied. *He was the chief legal adviser of the crown, and was entrusted with the management of all legal affairs, and the prosecution of all suits, civil and criminal, in which the crown was interested.* He had authority to institute proceedings to abate public nuisances affecting and endangering public safety and convenience; *he had the power to control and manage all litigation* on behalf of the state; he could intervene in all actions which were of concern to the general public, including the right to institute, conduct, and *maintain all suits necessary for the enforcement of the laws of the state, the preservation of order, and protection of the public rights.*[9]

As to the right of the attorney general to intervene in suits affecting the public interest, in *State ex rel. Allain v. Mississippi Public Service Commission*[10] the court stated: "The prevailing rule is that where the attorney general has common-law powers, he has the inherent right to intervene in all suits affecting the public interest when he has no personal interest therein."[11] Because the attorney general is Mississippi's chief legal officer who has the double duty of representing state agencies and protecting the public interest, the attorney general

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[6] *Wade*, 392 F. Supp. at 232 (emphasis added).

[7] *See supra* note 2 and accompanying text.

[8] 157 Miss. 576, 128 So. 759 (1930).

[9] *Capitol Stages*, 157 Miss. at 591, 128 So. at 763 (quoting 2 R.C.L. §§ 4-5, at 915-17 (1929)) (emphasis added).

[10] 418 So. 2d 779 (Miss. 1982).

[11] *Allain*, 418 So. 2d at 783.

should be allowed to intervene in suits to fulfill more effectively his duty to the public and to agencies, the *Allain* court held.[12]

One of the common-law powers is the duty to represent the state in litigation involving matters of statewide interest. In *Capitol Stages*, the Court stated that "[a]s to all litigation, the subject-matter of which is of state-wide interest, the Attorney General *alone* has the right to represent the state."[13] The *Capitol Stages* court further noted that despite early conflicting Mississippi decisions, the attorney general is unquestionably vested with common-law powers under a 1918 Mississippi statute that expressly confers common-law authority on the attorney general.[14] The court stated that "[h]e has the powers of the Attorney General at common law, and, in addition, such as have been conferred on him by statute; while the district attorneys have no powers . . . except those prescribed by statute."[15]

A legal encyclopedia,[16] concurring with the position taken by the court in *State v. Key*[17] and *Capitol Stages*,[18] recognizes that the attorney general is authorized to prosecute criminal cases whenever statewide interest so requires it.[19] Moreover, the attorney general has the sole right to determine what are matters of statewide interest.[20] That authority, however, has been limited by the Mississippi Supreme Court in *Frazier v. State ex rel. Pittman*.[21] The *Frazier* court ruled that when the attorney general refuses a request by a state agency to file a suit for the agency, the court, not the attorney general, ultimately determines whether the agency is entitled to have its suit heard.[22] In

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[12] *Id.* at 784. The court rejected a minority position that the attorney general could not intervene in a suit where he opposed a state agency. *Id.* at 783-84.

[13] *Capitol Stages*, 157 Miss. at 591, 128 So. at 764 (emphasis added).

[14] *Id.* at 589, 128 So. at 762 (citing 1918 Miss. Laws 238).

[15] *Id.* at 589-90, 128 So. at 763.

[16] 7 AM. JUR. 2D *Attorney General* §§ 6, 13 (1980).

[17] 93 Miss. 115, 118, 46 So. 75, 76 (1908).

[18] *Capitol Stages*, 157 Miss. at 589-90, 128 So. at 762-63.

[19] 7 AM. JUR. 2D, *supra* note 16.

[20] *See, e.g.*, State *ex rel.* Patterson v. Warren, 254 Miss. 293, 308, 180 So. 2d 293, 300 (1965) (attorney general empowered to bring suit in matters of statewide concern); Dunn Constr. Co. v. Craig, 191 Miss. 682, 711-12, 2 So. 2d 166, 174 (1941) (same).

[21] 504 So. 2d 675 (Miss. 1987).

[22] *Frazier*, 504 So. 2d at 691. The *Frazier* court added that the judiciary must find the suit is within the agency's duties before it will permit the agency suit to be prose-

noting that its holding does not usurp the attorney general's common-law, constitutional powers, the *Frazier* court pointedly stated, "*[o]ur holding today does not usurp the Attorney General of his common-law powers.*"[23]

That the attorney general, as the king's representative, was empowered to prosecute all criminal offenses at common law would appear to be unquestioned.[24] In describing the powers of the attorney general, Blackstone traced the powers of attorneys general from their inception, pointing out that early British attorneys general's powers were derived directly and expressly from the sovereign.[25] Their jurisdiction extended to important cases, often affecting the crown, which required immediate prosecution for one reason or another.[26] The attorney general could initiate prosecution of non-capital crimes by information (or suggestion), but the prosecution of a capital crime required "that the accusation be warranted by the oath of twelve men before the party" was "put to answer it."[27] Blackstone noted

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cuted. *Id.* That same year, the Mississippi Supreme Court dealt with this issue again in Dye v. State *ex rel.* Hale, 507 So. 2d 332, 338 (Miss. 1987). In finding that state senators had standing to challenge Senate rules, the *Hale* court stated: "We refuse to relegate to the Attorney General either the exclusive authority to bring a suit such as this or the discretion whether and how that authority should be exercised." *Id.*

[23] *Frazier*, 504 So. 2d at 692 n.16 (emphasis added).

[24] IV W. BLACKSTONE, COMMENTARIES ON THE LAW OF ENGLAND 301-23 (9th ed. 1893).

[25] III W. BLACKSTONE, *supra* note 24, at 28.

[26] IV W. BLACKSTONE, *supra* note 24, at 308-09.

[27] *Id.* at 310. Blackstone wrote:

> The objects of the king's own prosecutions, filed ex officio by his own attorney general, are properly such enormous misdemeanors, as peculiarly tend to disturb or endanger his government, or to molest or affront him in the regular discharge of his royal functions. For offenses so high and dangerous, in the punishment or prevention of which a moment's delay would be fatal, the law has given to the crown the power of an immediate prosecution, without waiting for any previous application to any other tribunal. The objects of the other species of information, filed by the master of the crown-office upon the complaint or relation of a private subject, are any gross and notorious misdemeanors, riots, batteries, libels, and other immoralities of an atrocious kind, not peculiarly tending to disturb the government (for those are left to the care of the attorney general) but which, on account of their magnitude or pernicious example, deserve the most public animadversion . . . .
>
> There can be do doubt but that this mode of prosecution by information (or suggestion) filed on record by the king's attorney general, or by his coroner or master of the crown-office in the court of king's bench is as ancient as the common law itself. For as the king was bound to prosecute, or at least to lend

that the king was bound to prosecute certain crimes and that over time such obligation was transferred to the attorneys general.[28] Their powers were such that, upon pronouncement by a grand jury of sufficient grounds, they were free to proceed with prosecutions in his majesty's name.[29]

The office of attorney general came to this country with colonization, with it being generally accepted that the attorney general possessed the common-law powers of the English attorney general except where such powers were changed by the Constitution or by statute.[30] The colonial attorney general "was in a sense a delegate of the Attorney General of England."[31]

A frequently cited landmark case detailing the attorney general's common-law powers is the New York case of *People v. Miner*,[32] which expressed the following rationale with respect to the effect of statutory enumeration of powers:

> As the powers of the attorney general were not conferred by statute, a grant by statute of the same or other powers would not operate to deprive him of those belonging to the office at common law, unless the statute, either expressly, or by reasonable intendment, forbade the exercise of powers not thus expressly conferred.[33]

> the sanction of his name to a prosecutor, whenever a grand jury informed him upon their oaths that there was a sufficient ground for instituting a criminal suit; so, when these his immediate officers were otherwise sufficiently assured that a man had committed a gross misdemeanor, either personally against the king or his government, or against the public peace and good order, they were at liberty, without waiting for any farther intelligence, to convey that information to the court of king's bench by a suggestion on record, and to carry on the prosecution in his majesty's name. But these informations (of every kind) are confined by the constitutional law to mere misdemeanors only; for, wherever any capital offense is charged, the same law requires that the accusation be warranted by the oath of twelve men before the party shall be put to answer it.

Id.

[28] *Id.*

[29] *Id.* at 308-09.

[30] *See supra* note 24 and accompanying text.

[31] O. HAMMONDS, THE ATTORNEY GENERAL IN THE AMERICAN COLONIES 3 (Anglo-American Legal History Series No. 1, 1939).

[32] 2 Lans. 396 (N.Y. App. Div. 1868).

[33] *Miner*, 2 Lans. at 399.

More recently, in *Slezak v. Ousdigian*,[34] the Minnesota Supreme Court emphasized that attorney general's powers are not limited by statute, but, in fact, extend to all authorities provided by common law.[35] The *Slezak* court stated: "He may institute, conduct, and maintain all such actions and proceedings as he deems necessary for the enforcement of the law of the state, the preservation of order, and the protection of public rights."[36]

Mississippi appears to follow the same rationale of *Miner* and *Slezak*, inasmuch as the courts have held that the constitutional creation of the office vested in the attorney general all powers which he possessed at common law and also incorporated common-law powers into the constitution itself.[37]

Thus, with the grant of all common-law powers vesting in the attorney general upon adoption of the Mississippi Constitution, and specifically section 173 thereof, the legislature may not take away or otherwise deprive the attorney general of his constitutional or common-law powers.[38] Moreover, it would appear that legislative attempts to erode the attorney general's section 173 constitutional common-law powers under purported authority of section 103 of the Mississippi Constitution, which provides that "[i]n all cases, not otherwise provided for in this constitution, the legislature . . . shall define their respective powers,"[39] would not only contravene the constitutional separation of powers rationale of *Alexander v. State ex rel. Allain*,[40] but would result in the direct violation of sections 1 and 2 of the Missis-

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[34] 260 Minn. 393, 110 N.W.2d 1 (1961).

[35] *Slezak*, 110 N.W.2d at 5 (overruled on different grounds in Christensen v. Minneapolis Mun. Employees Retirement Bd., 331 N.W.2d 740, 745 (Minn. 1983)).

[36] *Id.*

[37] *See, e.g.*, Wade v. Mississippi Coop. Extension Serv., 392 F. Supp. 229, 232 (attorney general's powers include all those possessed at common law); Kennington-Saenger Theatres, Inc. v. State *ex rel.* Dist. Att'y, 196 Miss. 841, 866, 18 So. 2d 483, 486 (1944) (same); Capitol Stages, Inc. v. State *ex rel.* Hewitt, 157 Miss. 576, 589-90, 128 So. 759, 763 (1930) (same); State v. Key, 93 Miss. 115, 118, 46 So. at 75, 76 (1908) (attorney general vested with common-law authority to prosecute appeals).

[38] *See* People *ex rel.* Barrett v. Finnegan, 378 Ill. 387, 38 N.E.2d 715, 717 (1941) (legislature precluded from stripping attorney general of any common-law powers of his office).

[39] Miss. Const. art. 4, § 103.

[40] 441 So. 2d 1329, 1335-38 (Miss. 1983).

sippi Constitution.[41]

The provisions of section 103 obviously did not deter the Mississippi Supreme Court in *Newell v. State*[42] from determining that legislative enactments involving judiciary matters were violative of the fundamental constitutional concept of separation of powers and vesting of powers in the courts.[43] The same court rejected a legislative enlargement of the Mississippi Rules of Evidence in *Hall v. State*.[44] The *Hall* court stated: "At its heart that doctrine of separation of powers provides that no officer of one department of government may exercise a power at the core of the power constitutionally committed to one of the other departments."[45]

Similarly, following the attorney general's initiation of a suit against the United States Army Corps of Engineers,[46] in a matter which stirred controversy among some Mississippi legislators, the legislature attempted by indirect means to usurp the fundamental section 173 constitutional power of the attorney general, as well as the express statutory authority of the office to act both in matters of statewide interest and in the duty to represent the state and its officers,[47] by inserting the following language in the appropriation bill for the general support of the Office of Attorney General: "No funds authorized to be expended herein shall be expended with respect to any litigation

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[41] MISS. CONST. art. 1, §§ 1, 2. Section 1 mandates that "[t]he powers of the government of the state of Mississippi shall be divided into three distinct departments, and each of them confided to a separate magistracy, to-wit: those which are legislative to one, those which are judicial to another, and those which are executive to another." MISS. CONST. art. 1, § 1. Section 2 further directs that "[n]o person or *collection of persons, being one or belonging to one of these departments, shall exercise any power properly belonging to either of the others.*" MISS. CONST. art. 1, § 2 (emphasis added).

[42] 308 So. 2d 71 (Miss. 1975).

[43] *Newell*, 308 So. 2d at 77; *accord* Hall v. State, 539 So. 2d 1338, 1345 (Miss. 1989) (separation of powers doctrine held to invalidate legislative rules of evidence).

[44] 539 So. 2d 1338 (Miss. 1989).

[45] *Hall*, 539 So. 2d at 1345 (citing Alexander v. State *ex rel.* Allain, 441 So. 2d 1329, 1345-46 (Miss. 1983)).

[46] State *ex rel.* Moore v. Marsh, 710 F. Supp. 1488, 1491 (S.D. Miss. 1989). In *Marsh*, Mississippi Attorney General Mike Moore brought suit against the United States Army Corps of Engineers for violation of environmental regulations in its handling of the Yalobusha River Maintenance Project. *Id.* at 1489-91.

[47] MISS. CODE ANN. §§ 7-5-1 to -39 (1972). These code sections embody the statutory authority given to the Mississippi Attorney General. *Id.*

involving the United States Army Corps of Engineers and its work on any flood control project in this state."[48] Not only was the attorney general undeterred by this apparent attempt to usurp his constitutional authority, but the Governor promptly vetoed the aforesaid provision of the appropriations bill.

II. Statutory Authority

Not only has the supreme court held in cases such as *Kennington-Saenger* that the common-law powers of the attorney general are elevated to constitutional stature by article 6, section 173, of the Mississippi Constitution, but the Mississippi Legislature has also reaffirmed by statute the authority of the attorney general to exercise these common-law powers in section 7-5-1 of the Mississippi Code of 1972, as amended, which provides:

> The attorney general . . . shall be the chief legal officer and advisor for the state, *both civil and criminal*, and is charged with managing all litigation on behalf of the state. No arm or agency of the state government shall bring or defend a suit against another such arm or agency without prior written approval of the attorney general. *He shall have the powers of the attorney general at common law and is given the sole power to bring or defend a lawsuit* on behalf of a state agency, the subject matter of which is *of statewide interest.*[49]

Consistent with the attorney general's constitutional powers and his authority under section 7-5-1, the legislature has also codified other specific areas of the attorney general's authority to prosecute actions, which include prosecuting and/or defending causes to which the state is a party,[50] enforcing judgments[51]

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[48] H.B. 1428, § 3 (1989).

[49] Miss. Code Ann. § 7-5-1 (1972)(emphasis added).

[50] *Id.* § 7-5-29.

> The attorney general shall attend the supreme court, in person or by his assistant, and prosecute and defend therein all causes to which the state or any officer thereof in his official capacity is a party, and all causes to which any county may be a party unless the interest of the county be adverse to the state, to some officer thereof acting in his official capacity, or to some other county.

Id.

[51] *Id.* § 7-5-33. "After judgment in any cause represented by him, the attorney general shall direct the issuing of such process as may be necessary to carry the same into

and collecting debts due the state.[52] The statutes go on to specifically endow the attorney general with powers to prosecute and/or defend bond or contract actions to which the state is a party,[53] to represent the state in courts other than the Mississippi Supreme Court,[54] and to institute suits on the part of the state against state officials for neglect of their duties,[55] or arising from any act or order of the State Tax Commission or Public Service Commission.[56] The attorney general also is authorized to assist district attorneys in performing their duties "when required by the public service or when directed by the governor."[57]

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execution." *Id.*

[52] *Id.* § 7-5-35.

When it may be necessary or proper for the enforcement or collection of any judgment or debt in favor of the state, or any officer thereof in his official capacity, or of any county, the attorney general shall institute and prosecute in behalf of the creditor a suit or suits to set aside and annul any conveyance or other device fraudulently made by the debtor, or anyone for him, to hinder, delay, or defraud the creditor.

Id.

[53] *Id.* § 7-5-37.

The attorney general shall, at the request of the governor or other state officer, in person or by his assistant prosecute suit on any official bond, or any contract in which the state is interested, upon a breach thereof, and prosecute or defend for the state all actions, civil or criminal, relating to any matter connected with either of the state offices. He may require the service or assistance of any district attorney in and about such matters or suits.

Id.

[54] *Id.* § 7-5-39.

The attorney general shall also represent the state, in person, or by his assistant, as counsel in all suits against the state in other courts than the supreme court at the seat of government, and he shall, in like manner, act as counsel for any of the state officers in suits brought by or against them in their official capacity, touching any official duty or trust and triable at the seat of government. He may pursue the collection of any claim or judgment in favor of the state outside of the state.

Id.

[55] *Id.* § 7-5-47. "The attorney general or his assistant, when required by the governor, shall institute suits for the benefit of the state on the bond of any state officer in any case in which said officer has been guilty of any neglect or violation of his official duties." *Id.*

[56] *Id.* § 7-5-51. "The attorney general, as well as the several district attorneys, is hereby authorized to institute or defend any suits arising out of any act or order of the tax commission or the public service commission affecting the laws and revenues of the state." *Id.*

[57] *Id.* § 7-5-53.

The attorney general shall, when required by the public service or when di-

Statutes further empower the attorney general to investigate and prosecute official corruption and such other white-collar crimes which are of statewide interest or which are in the protection of public rights,[58] to prosecute Medicaid fraud,[59] to prosecute lobbying offenses,[60] to seek temporary or permanent injunctions for consumer protection[61] and to prosecute certain

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rected by the governor, in writing, report in person, or by any regular or specially designated assistant, to any county or district in the state and assist the district attorney there in the discharge of his duties and in any prosecution against a state officer, and shall have the same right as the district attorney to enter the grand jury room while the grand jury is in session and to perform such services with reference to the work of the grand jury as the district attorney is authorized by law to perform.

Id.

[58] *Id.* § 7-5-59(2)(Supp. 1989). This section states: "The Attorney General is hereby authorized to conduct official corruption investigations and such *other white-collar* crime investigations that are of statewide interest or which are in the protection of public rights." *Id.* (emphasis added).

In addition to authorizing the attorney general to investigate white-collar crime, Mississippi statutory law further directs him to prosecute such crimes. *Id.* § 7-5-54(1) (Supp. 1989). This section states:

> In addition to the authority granted in Section 7-5-53, Mississippi Code of 1972, the Attorney General shall prosecute, in person or by his designated staff attorney, criminal matters and cases investigated by him pursuant to the provisions of Section 7-5-59 and he may request the services or assistance of any district attorney in and about such matters or suit. When requested by a district attorney and in the public interest, the Attorney General may, in person or by his designated staff attorney, assist the district attorney in the discharge of his duties. The Attorney General or his designated staff attorney shall have the same right as the district attorney to enter the grand jury room while the grand jury is in session and to perform such services with reference to the work of the grand jury as the district attorney is authorized by law to perform.

Id.

The authorization for the attorney general to investigate and prosecute white-collar crime does not diminish local officials' right to do the same. *Id.* § 7-5-54(2) (Supp. 1989).

[59] *Id.* § 43-13-219 (Supp. 1989). It reads: "There is hereby created within the office of the attorney general a 'Medicaid Fraud Control Unit.' The unit shall consist of a director appointed by the attorney general and such attorneys, auditors, investigators and other such personnel as are necessary to conduct the activities of the unit." *Id.*

[60] *Id.* § 5-7-19 (Supp. 1989). "It shall be the duty of the attorney general of the State of Mississippi to prosecute any offense under the provisions of this chapter [Lobbying Act, Laws of 1977. Ch. 388] and he shall have all powers and privileges of a district attorney for that purpose." *Id.*

[61] *Id.* §§ 75-24-9, 75-24-17 (Supp. 1989).

> Whenever the attorney general has reason to believe that any person is using, has used, or is about to use any method, act or practice prohibited by section 75-24-5 of the Consumer Protection Act and that proceedings would be in the

elected officials for violating income-reporting requirements.[62] The attorney general must be confidentially informed by the Ethics Commission of suspected violations supported by probable cause[63] and must enter notices of removal for state officials

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public interest, he may bring an action in the name of the state against such person to restrain by temporary or permanent injunction the use of such method, act or practice, upon at least five (5) days summons before the hearing of the action.

Id. § 75-24-9.

Section 75-24-17 states:

If any person willfully fails or refuses to file any statement or report, or fails or refuses to obey any subpoena or investigative demand issued by the attorney general, the attorney general may, after notice, apply to the chancery or county court of the county in which such person resides or has his principal place of business, or if the person be absent or a nonresident of the State of Mississippi, of such court of the county in which the state capitol is located, and, after hearing thereon, request an order:

(a) Granting injunctive relief to restrain the person from engaging in the advertising or sale of any merchandise or the conduct of any trade or commerce that is involved in the alleged or suspected violation;

(b) Vacating, annulling, or suspending the corporate charter of a corporation created by or under the laws of this state or revoking or suspending the certificate of authority to do business in this state of a foreign corporation or revoking or suspending any other licenses, permits or certificates issued pursuant to law to such person which are used to further the allegedly prohibited practice; and

(c) Granting such other relief as may be required, until the person files the statement or report, or obeys the subpoena or investigative demand.

Id. § 75-24-17 (Supp. 1989).

[62] *Id.* § 7-3-47(1) (Supp. 1989).

On or before April 20 of each year, the secretary of state shall notify by mail every elected official being compensated in whole or in part on a fee basis, including, but not limited to, every chancery clerk, circuit clerk and constable who has failed to file the report required by section 7-3-45; and on or before May 15 of each year, he will notify the attorney general of the ones of same by name who still have not filed such report, and the attorney general shall thereupon prosecute such delinquent officers.

Id.

[63] *Id.* §§ 25-4-21e(iii), 25-4-113 (Supp. 1989).

If . . . investigation indicates probable cause for belief that a violation of law has occurred, the [Ethics] commission shall, confidentially, refer the complaint with any evidence gathered during the investigation to the Attorney General and to the district attorney having jurisdiction, with a recommendation that it be considered for presentation to the grand jury, as well as any further recommendations for seeking civil remedies.

Id. § 25-4-21e(iii). The related statute provides:

The attorney general of the state of Mississippi or any governmental entity directly injured by a violation of this [Ethics in Government] act may bring a

convicted of felonies.[64]

III. Private Attorney General and Parens Patriae Authority Under Federal Law

In addition to state statutory authority available in antitrust enforcement and in the deterrence of racketeering activity, federal statutes provide significant authority for state attorneys general to initiate civil actions in United States district courts in such matters.[65]

Of paramount importance to state agencies and to the citizens of each state is the rapidly increasing role of state attorneys general in the bringing of civil actions in federal district courts under private attorney general and/or *parens patriae* provisions of the Sherman Act of 1890,[66] the Clayton Act,[67] and the Hart-Scott-Rodino Antitrust Act of 1976.[68] Civil sanctions under these federal statutes include injunctive relief, treble damages, and recovery of attorneys' fees and court costs.[69]

Like the federal antitrust statutes, the Racketeer Influenced and Corrupt Organizations Act (RICO) also includes provision for civil action under the private attorney general concept; but,

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separate civil action against the public servant or other person or business violating the provisions of this article for recovery of damages suffered as a result of such violation.

Id. § 24-4-113.

[64] *Id.* § 25-5-1 (Supp. 1989).

When any such officer [state, district, county or municipal] is found guilty of a crime which is a felony under the laws of this state or which is punishable by imprisonment for one (1) year or more, other than manslaughter or any violation of the United States Internal Revenue Code, in a federal court or a court of competent jurisdiction of any other state, the Attorney General of the State of Mississippi shall promptly enter a motion for removal from office in the circuit court of Hinds County in the case of a state officer, and in the circuit court of the county of residence in the case of a district, county or municipal officer.

Id.

[65] *See, e.g.*, Miss. Code Ann. §§ 75-21-1 to -9 (1972) (relating to antitrust enforcement); Miss. Code Ann. § 97-43-1 (1972) (relating to Mississippi RICO Act).

[66] Sherman Act of 1890, 15 U.S.C. §§ 1-7 (Supp. 1986).

[67] Clayton Act, 15 U.S.C. §§ 12-27 (Supp. 1986).

[68] Hart-Scott-Rodino Antitrust Act of 1976, 15 U.S.C. § 15(c) (Supp. 1986).

[69] Sherman Act of 1890, 15 U.S.C. § 1; Clayton Act, 15 U.S.C. §§ 12-14, Hart-Scott-Rodino Antitrust Act of 1976, 15 U.S.C. § 15(c).

unlike the federal antitrust statutes, does not authorize *parens patriae* actions.[70] In such role, attorneys general, as well as other governmental entities, have potent weapons available for use in restoring to public treasuries illegally gotten gains and in deterring racketeering activity. The civil RICO statute[71] provides for recovery of treble damages for injuries sustained and for costs of suit, including reasonable attorneys' fees.[72]

State antitrust enforcement in federal courts in past years usually has been limited to "follow-on" cases after federal indictment or civil suit.[73] More recently, attorneys general increasingly have addressed antitrust problems of multi-state or national scope, and have joined together in cooperative investigations and joint actions to block or rectify anti-competitive business measures.[74]

These foregoing federal statutes provide an effective means of striking at white collar criminals where it hurts—in the pocket book. This, coupled with the advent and usage of computers for retrieval, sorting and evaluation of the massive amounts of information and data usually found in antitrust and racketeering activities, will, in the opinion of this writer, increase "follow-on" civil enforcement cases by state attorneys general pursuing federal indictments. This should be especially true in the price fixing, bid rigging, bribery, fraud against the government and official corruption illegalities. This writer further believes that significant increases in joint efforts in cooperative multi-state or national scale antitrust cases by attorneys general will occur.

IV. Subpoena and Investigative Powers

As is noted from a review of the foregoing cited constitu-

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[70] Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C. §§ 1961-1966 (Supp. 1986).

[71] *Id.* § 1961.

[72] Illinois Dep't of Revenue v. Phillips, 771 F.2d 312, 316 (7th Cir. 1985); Alcorn County, Miss. v. United States Interstate Supplies, Inc., 731 F.2d 1160, 1164-65 (5th Cir. 1984); Pennsylvania v. Cianfrani, 600 F. Supp. 1364, 1368 (E.D. Pa. 1985).

[73] National Association of Attorneys General, The Office of Attorney General: Powers & Duties 379 (1988).

[74] *Id.*

tional and statutory authorities empowering the attorney general, either generally or specifically, to conduct a criminal prosecution, it would appear that his common-law power accords him the right to do any act which a district attorney might do even without statutory recognition of subpoena and/or investigative authority; that is, the attorney general can do each and every thing essential to prosecute in accordance with the law of the land, including investigating and appearing before a grand jury in prosecuting a criminal action.[75]

However, assuming arguendo that there is no recognition of the section 173 constitutional powers of the attorney general, it still would appear that under the foregoing cited general statutes, sections 7-3-47, 7-5-1, -37, -59(2), and 75-24-1, -61, the attorney general has the implied authority to investigate and/or appear before a grand jury in the prosecution of criminal actions under such statutes.[76] But, whether he has the implied statutory power to do so, sections 7-5-54(1), 43-13-221, 5-7-19, and 25-4-21(e)(iii), hereinabove set forth, provide specific legislative grants of statutory authority for the attorney general to investigate and/or appear before a grand jury in such specified criminal actions.[77]

In addition to the aforesaid statutory recognition of the attorney general's right to utilize the grand jury, section 7-5-59(3)(a) of the Mississippi Code, effective from and after July 1, 1988, authorizes the attorney general to issue and serve administrative subpoenas for the production of documents and other material pertinent to white collar crime investigations:

> [U]pon the ex parte and in camera application of the attorney general to the circuit or chancery court of the county of residence of the person in control of the documents or in the circuit or chancery court of the county where the documents may be found upon a showing that the documents sought are relevant to a white collar investigation.[78]

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[75] State v. Finch, 128 Kan. 665, 280 P. 910, 911 (1929); *see* People v. Crawford Distrib. Co., 53 Ill. 2d 332, 291 N.E. 2d 648, 656 (1972) (duties of attorney general include not only those granted by statute but also those powers from common law).

[76] Miss. Code Ann. §§ 7-3-47, 7-5-1, -37, -59(2), 75-24-1 to -61 (Supp. 1989).

[77] *Id.* §§ 7-5-54(1), 7-5-53, 43-13-221, 5-7-19, 25-4-21(e)(iii) (Supp. 1989).

[78] Laws, 1988 Chapter 511, § 1 [House Bill No. 1, Regular Session 1988].

In such an investigation, section 7-5-59(5) authorizes the attorney general to request a court order granting use immunity to a subpoenaed person for any self-incriminating document compelled under such order, or for any information directly or indirectly derived from such information, except for prosecution for perjury, the giving of a false statement, or otherwise failing to comply with the order.[79] The "use" and "derivative use" immunity provisions of section 7-5-59(5), patterned after federal statutes,[80] were adopted to reflect the "use" and "derivative use" immunity concept of the Organized Crime Control Act of 1970,[81]

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[79] MISS. CODE ANN. § 7-5-59 (Supp. 1989).

[80] 18 U.S.C. § 6001 (Supp. 1985). Until enactment of House Bill No. 1, 1988 Regular Session, Mississippi's immunity statutes, like federal statutes prior to 1970, provided only full or transactional immunity for witnesses compelled pursuant to statute to testify or produce documents in administrative, judicial and legislative proceedings. These statutes are MISS. CODE ANN. § 5-1-25 (compelled testimony or production of documents before either house of legislature); § 75-71-715 (Supp. 1989) (securities proceedings before Secretary of State); § 97-9-10 (Supp. 1989) (commercial bribery prosecution); § 99-17-23 (dueling prosecution or proceeding, civil or criminal); § 99-17-27 (gambling and future contracts prosecution, penalty or forfeiture); § 99-17-29 (lottery prosecution); § 99-17-31 (prosecution of legislative offenses); and § 97-31-51 (Supp. 1989) (intoxication beverage prosecution, penalty of forfeiture).

[81] 18 U.S.C. § 6001 (1986). James Cissell provides the following succinct explanation of the Act:

> The Organized Crime Control Act of 1970 added sections 6001-6005 to title 18 of the United States Code, creating a single comprehensive provision to govern immunity grants in judicial, administrative, and congressional proceedings, and amending or repealing all prior immunity provisions. The immunity granted under this provision is that 'no testimony or other information compelled under the order (or any information directly or indirectly derived from such testimony or other information) may be used against the witness in any criminal case. . . .'
>
> The act was designed to reflect the 'use' and 'derivative use' immunity concept of Murphy v. Waterfront Commission, 378 U.S. 52 (1964), rather than the 'transactional' immunity concept of Counselman v. Hitchock, 142 U.S. 547 (1892). This statutory immunity is intended to be as broad as, but no broader than, the privilege against self-incrimination. In Kastigar v. United States, 406 U.S. 441, 462 (1972), the Supreme Court held that this limited grant of immunity by which testimony is compelled under threat of imprisonment is constitutional: 'We conclude that the immunity provided by 18 U.S.C. § 6002 leaves the witness and the prosecutorial authorities in substantially the same position as if the witness had claimed the fifth amendment privilege. The immunity therefore is coextensive with the privilege and suffices to supplant it.'

J. CISSELL, PROVING FEDERAL CRIMES § 3-13 (1980).

> Once the witness has been granted immunity, he may not refuse to testify on the ground of the privilege against self-incrimination. Such refusal may be fol-

rather than the "transactional" immunity concept of *Counselman v. Hitchock*,[82] *State v. Billups*,[83] *Wheat v. State*,[84] and

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lowed by contempt and a sentence. . . . However, a witness may not be held in contempt if the body or court before which he testified clearly led him to believe he might still claim the privilege. Raley v. Ohio, 360 U.S. 423, 440-42 (1959).

J. CISSELL, *supra*, § 3-14.

Even after a witness has been granted 'derivative use' immunity, he may still be prosecuted for crimes about which he has testified. Kastigar v. U.S., 407 U.S. 441, 453 (1972). Such prosecutions, however, face two hurdles. First, because it is the policy of the Department of Justice to avoid future prosecutions of witnesses for offenses disclosed under a grant of immunity, any such prosecution must be authorized in writing and personally signed by the attorney general. Second, the immunity prohibits the prosecution from using the compelled testimony in any respect. The testimony therefore may not be used either for investigative leads or to focus investigation on the witness. Once the defendant establishes that he has testified under a grant of immunity to matters related to the federal prosecution, the government has an affirmative duty to prove that the evidence it proposes to use is derived from a legitimate source wholly independent of the compelled testimony. *Kastigar*, 406 U.S. at 460 (citing Murphy v. Waterfront Comm'n, 378 U.S. 52, 79 n.18 (1964)). That is, the government cannot satisfy its burden merely by denying that immunized testimony was used; it must affirmatively prove an independent source of evidence. United States v. Nemes, 555 F.2d 51, 55 (2d Cir. 1977).

J. CISSELL, *supra*, §§ 3-14, 3-15.

Statutory "use" and "derivative" immunity provisions had previously been sought by attorneys general in previous requests for administrative subpoena power for testimony and documents. *See* S. 2354, 1987 Reg. Sess.; S. 2078, 1986 Reg. Sess.; S. 255, 1983 Reg. Sess.; S. 2037, 1982 Reg. Sess.; S. 2591, 1980 Reg. Sess.

Presumably aware that the 1892 legislative subpoena statute, § 5-1-25 of the Mississippi Code, resulted in the granting of full or transactional immunity in Wheat v. State, 201 Miss. 890, 900-02, 30 So. 2d 84, 87-88 (1947) and in following cases and of an unsuccessful endeavor to use it in Cassibry v. State, 404 So. 2d 1360, 1370 (Miss. 1981), Representatives Barefield and Meredith submitted a legislative "use" and "derivative" immunity proposal. The bill contained the following stated purpose:

To adopt as far as practical the language of the federal statutes in providing that criminal sanctions be imposed for contempt of the Mississippi Legislature and also in changing the type of immunity granted by the Legislature in order that the judicial decisions derived from such federal statutes may be utilized to further define and delineate the rights and obligations of the Mississippi Legislature and the joint committees and subcommittees thereof and of witnesses before such bodies.

H.R. 319, 1981 Reg. Sess. The same intent of the legislature had also been stated a year earlier in the proposed Committee Substitute for House Bill No. 614, 1980 Regular Session. Each of these bills had proposed to amend the statutory grant of legislative immunity provisions of § 5-1-25 that provided for "use" and "derivative use" immunity.

[82] 142 U.S. 547 (1892).

[83] 179 Miss. 352, 174 So. 50 (1937).

Kellum v. State.[85] The federal "use" and "derivative use" provisions were approved in *Kastigar v. United States.*[86] However, the immunity provisions of section 7-5-59(5) are likely to be challenged in view of language (which appears to this writer to be dicta) in the Mississippi case of *Wright v. McAdory.*[87]

V. Attorney General's Responsibilities for Law Enforcement Flowing from the Chief Executive Powers of the Governor

The governor is the chief law enforcement officer of the state.[88] The Mississippi Constitution vests the chief executive power of this state in the governor, and section 123 mandates

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[84] 203 Miss. 890, 30 So. 2d 84 (1947).

[85] 194 So. 2d 49 (1967).

[86] 406 U.S. 441, 462 (1972).

[87] 536 So. 2d 897, 899 (Miss. 1988). On facts predating enactment of the use and derivative use immunity provisions of § 7-5-59(5), the new statutory immunity provisions may be susceptible to challenge. Neither of the briefs in *Wright* filed by the parties, nor does the opinion, indicate knowledge of the enactment of § 7-5-59(5). In the context of *Wright* the court opines that such type of immunity would be impermissible under § 26 of the Mississippi Constitution of 1890. *Id.* at 904. The absence of any mention of the use and derivative use immunity provisions of § 7-5-59(5) by the court in *Wright*, or by the parties in their briefs, may indicate either a lack of awareness of the statute's existence, or a recognition of its inapplicability because the facts in *Wright* predated the July 1, 1988, effective date of the statute, or because it was recognized that only transactional immunity is constitutionally permissible under § 26 (as well as under the fifth amendment of the United States Constitution) in the absence of use and derivative use statutory provisions which leave the witness in same position as if he had not been compelled to testify—nothing more and nothing less. Miss. Code Ann. § 5-1-25 (1972). The immunity statute utilized to confer immunity in *Billups*, *Wheat*, and *Kellum*, and § 99-15-53, the statute construed by the Court as authority for conferring immunity in *Wright*, are conspicuously devoid of any provision which would limit the statutorily authorized immunity to "use" or "derivative use" immunity. It would thus appear that the discussion of use and derivative use immunity in *Wright* should be considered as dictum, inasmuch as the only possible type of immunity available to Wright was transactional immunity, which the court so found. Finally, because of the possible implication in *Wright* that the tendered plea agreement with which Wright refused to comply would satisfy fifth amendment standards, thus creating a need to construe § 26 of the Mississippi Constitution of 1890 in order to resolve the issue of privilege against self-incrimination, it is respectfully suggested that the tendered plea agreement was not enforceable under the fifth amendment because it clearly led Wright to believe that he might be subject to prosecution by others. A witness may not be held in contempt if the body or court before which he testified clearly led him to believe he might still claim the privilege. Raley v. Ohio, 360 U.S. 423, 437 (1959).

[88] Miss. Const. of 1890 art. V, §§ 116, 123.

that the governor "see that the laws are faithfully executed."[89] These constitutional powers have also been codified by the legislature in section 7-1-5, Mississippi Code of 1972, which provides: "[The governor] is the supreme executive officer of the state. . . . He shall see that the laws are faithfully executed. . . . He may require the attorney general to aid any district attorney in the discharge of his duties."[90] *In State v. McPhail*,[91] the Mississippi Supreme Court further emphasized that the governor possessed execution powers superior to those of local law enforcement officials; although much care had been taken to preserve local authority, the governor must maintain such authority in order to insure the uniform enforcement of the laws in all localities.[92] The court noted that the drafters of the Constitution intentionally vested such powers in the governor so that he might set the enforcement machinery in motion when local officials for one reason or another have failed to do so.[93] In recognition of such powers the Supreme Court stated:

> The constitutional and statutory provisions requiring the Governor to see that the laws are executed have no obscure or technical meaning; neither were they intended as a mere verbal adornment of his office. They mean what is in the ordinary import of the language used, to wit, that the laws shall be carried into effect, that they shall be enforced. And when this language

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[89] *Id.*

[90] MISS. CODE ANN. § 7-1-5(a), (c), (i) (Supp. 1989).

[91] 182 Miss. 360, 180 So. 387 (1938).

[92] *McPhail*, 182 Miss. at 372, 180 So. at 390.

[93] *Id.* at 372, 180 So. at 390. The court stated:

> A permeating feature in our State Constitution, and in all State Constitutions, is that primary local authority shall be preserved, so far as practically possible. The execution of civil and criminal process—the execution of the laws—was and is no exception to this structural rule. It was foreseen, however, by the framers of the Constitution that for one cause or another, local conditions would sometimes arise which would render the local authorities powerless to enforce the laws, or unwilling or afraid to do so. It was to meet such conditions, as one of its purposes, that the constitutional and statutory authority which we have above mentioned in respect to the execution of the laws was vested in the Governor. The Constitution makers did not leave any such loophole as to permit statutes enacted for general observation throughout the state to be set aside, or in practical effect repealed, in any particular section or area by the device of a failure or refusal of the local authorities to enforce such statutes.

Id. at 390.

> is taken in connection with section 9 of the Constitution, it means, of course . . . not that there shall be an arbitrary enforcement by the executive of what he may consider the law to be, but the enforcement of judicial process that is, the enforcement of a right or remedy provided by the law and judicially determined and ordered to be enforced, and it includes criminal as well as civil process; and the term "process" is used here in its broadest sense, so long as it is a judicial process. All these provisions, when taken together, mean that whatever the Governor does in the execution of the laws, or whatever members of the militia do, under such authority, must be as civil officers, and in strict subordination to the general law of the land.[94]

And as discussed earlier, section 7-5-53 provides that the governor may direct the attorney general to assist the district attorney in any county or district of the state in the discharge of the district attorney's duties and in the prosecution of a state officer.[95]

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[94] *Id.* at 371, 180 So. at 390.

> Thus and for the stated reason, the chief executive was given the authority and it was made his duty to act to enforce the laws, duly and constitutionally enacted, in every portion of the state, so that every citizen and all property would have the protection of the laws and that every criminal statute should be observed. Thus the power to enforce the laws is not left as a matter of finality to the discretion of the local authorities or the local inhabitants; but power was placed in the head of the executive department to act, in case of need, for the whole state. The Governor is an executive officer in every county of the state; and he may set the enforcement machinery in motion and thereby determine to whom the civil process may be directed for execution, when that has become proper on account of failure, neglect, or inability of the local executive officers to act. Every power at his command given by the Constitution and statutes may be brought into play so far as needed to effect the enforcement of the law.

Id.

[95] *See supra* notes 51, 71 and accompanying text. The *McPhail* court stated:

> A fair measure of deference must be accorded to the local authorities, but when, as here, the governor has sought by representations to, and requests of the local authorities that the law be enforced, and they fail to do so; when their failure becomes tantamount in substantial results to a refusal, or to no more than a futile pretense; when the condition exists and persists for that length of time which makes it clearly apparent that no dependence is to be placed upon the local executive officers and that they either cannot or will not enforce the laws, so that as respects all offenses of a certain class or classes, or as to any class or classes of civil process, there has been a substantial breakdown of local enforcement. At that point the power and duty of the governor arises to send the executive agents with which the law has armed him, to wit, the militia, not

Thus, in addition to the constitutional and statutory powers of the attorney general to investigate and prosecute civil and criminal actions, as discussed above in Parts I through IV, when the governor directs him to provide assistance upon a breakdown in local law enforcement, the attorney general also has local law enforcement responsibilities which flow to him as a result of the exercise of chief executive powers by the governor.[96] From a practical viewpoint, however, a significant amount of investigative and prosecutorial assistance in local law enforcement matters results from specific requests of local officials and the attorney general's rendering assistance on the basis of such being required by the public service, as set forth in section 7-5-53 of the Mississippi Code of 1972.[97]

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at all to supersede the law, but to enforce it. The members of the militia are simply performing the duties which the local executive officers would and could perform were they immediately present and were they performing their duties as they ought to do and ought to have done.

Id. at 373-76, 180 So. at 391.

[96] *Id.*

[97] MISS. CODE ANN. § 7-5-53 (1972)(Supp. 1989).

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COMMENTS

AFFIRMATIVE ACTION MINORITY SET-ASIDES: FUTURE JUSTIFICATION FOR IMPLEMENTATION AT THE STATE AND/OR LOCAL GOVERNMENT LEVEL*

Introduction

Traditionally, qualified minority entrepreneurs with general business skills have been in short supply in the American economy. This deficiency can be attributed to the past exclusion of minorities from the mainstream economy dating all the way back to the institution of slavery.[1] Nevertheless, a recitation of past obstacles that assisted in the exclusion of minorities from mainstream economic fields is not necessary, for everyone is painfully aware of America's shameful history of discrimination toward minorities, sanctioned and legalized by law and policy. Accordingly, this comment will focus on recent constitutional developments regarding minority set-asides at various governmental levels as a result of changed political circumstances and how such developments impact upon the continuing struggle for racial equality.

Minority Business Enterprise (MBE)[2] set-asides were conceptual-

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[1] *See generally* A. Higgenbotham, In the Matter of Color: Race and the American Legal Process: The Colonial Period (1978)(early history of blacks in America); Comment, Mitchell v. Freeman, Et Al.: *Judicial Enforcement of Affirmative Action Set Asides—Overcoming the Economic Remnants of Slavery*, 7 Black L.J. 213, 223-25 (1981)(general discussion of plight of black businessmen).

[2] The terms "minority business enterprise" and/or "set-aside," for purposes herein, will refer to any statutory or regulatory program that requires a certain percentage of public contracting funds to be dispersed among minority-owned businesses.

ized through the efforts of government, on both the state and federal level, to encourage minority business ownership and success. These assistance programs are geared toward encouraging economic development among those previously denied such opportunities by ensuring minority owned businesses a larger share of government business dollars, particularly in regard to governmental expenditures in the construction area.[3]

At the present, however, MBE set-aside programs are undergoing changes with respect to the permissible methods of government implementation. These changes are predicated upon the need to designate the circumstances in which the use of a racial preference is practically, as well as constitutionally, appropriate.[4] Accordingly, in the recent case of *City of Richmond v. J.A. Croson Co.*,[5] the United States Supreme Court finally established some definable guidelines which must be adhered to by governments seeking to employ minority set-aside programs.[6] In an effort to better understand and appreciate the full meaning and impact of the *Croson* decision upon minority remedial legislation, a brief chronological analysis of the affirmative action set-

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[3] *See* R. GLOVER, MINORITY ENTERPRISES IN CONSTRUCTION 1-2 (1977)(construction industry offers employment and entrepreneurial opportunities to minorities which would otherwise be unattainable). The construction industry was targeted by MBE set-aside programs because it offered a variety of opportunities which greatly enhanced the social and economic status of minorities. This is because construction is a high-wage growth industry with relatively easy entrance requirements heavily influenced by government involvement and participation. Thus, it is only logical that the construction industry serve as the mode for implementation of affirmative action set-asides. *See generally* Sroka, *Minority and Women's Business Set-Asides: An Appropriate Response to Discrimination*, 1 SELECTED AFFIRMATIVE ACTION TOPICS IN EMPLOYMENT AND BUS. SET-ASIDES, 90, 90-91 (1985) (discussing construction industry as appropriate means for set-aside programs).

[4] Levinson, *A Study of Preferential Treatment: The Evaluation of Minority Business Enterprise Assistance Programs*, 49 GEO. WASH. L. REV. 61, 63 (1980). Some commentators suggest implementing changes to determine the overall efficiency and fairness of set-asides. *Id.* at 99. This present view is premised upon the very realistic economic problems confronting most government entities. Thus, considering the above, economic necessity mandates that any program which deviates from the fundamental free enterprising concept must be carefully scrutinized. *Id.*

[5] 109 S. Ct. 706 (1989).

[6] *Croson*, 109 S. Ct. at 727-29. The Court, in determining what evidence must be presented by a local government in order to satisfy the constitutional requirements of the fourteenth amendment, set forth guidelines for implementing a minority set-aside. *Id.* The government, with the exception of the federal government, must identify the past discrimination with specificity, evaluate all possible race-neutral solutions, and make sure the set-aside, if determined a necessary measure, is "narrowly tailored" in scope. *Id.*; *see infra* notes 33-62 and accompanying text.

aside is imperative.

I. Supreme Court's Initial Confrontation with Affirmative Action Question

The United States Supreme Court first addressed the affirmative action question in *University of California Regents v. Bakke*.[7] In this initial confrontation, the Court began its analysis by determining the proper level of scrutiny to be accorded affirmative action programs.[8] Although the Court had theretofore adjudicated racial classifications with strict scrutiny,[9] the race-conscious plan under evaluation in *Bakke* was unique in that it intended to promote social equality by counteracting past racial discrimination.[10]

The issue adjudicated in *Bakke* was the University of California at Davis Medical School's affirmative action admissions program.[11] The program reserved sixteen places in the entering class for minority group members.[12] Hence, white applicants, regardless of their credentials, were excluded from the specially designated minority positions solely because of their skin color.[13] Because of the program's outright discriminatory exclusion of whites, the admissions policy was attacked under the United States Constitution as being violative of the equal protection clause of the fourteenth amendment.[14]

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[7] 438 U.S. 265 (1978).

[8] *Bakke*, 438 U.S. 287-320.

[9] *See* Loving v. Virginia, 388 U.S. 1, 11 (1967) (racial classification evaluated under strict scrutiny standard); McLaughlin v. Florida, 379 U.S. 184, 192 (1964) (same). *See generally* Comment, *Minority Business Enterprise Set-Aside: The Reverse Discrimination Challenge*, 45 Alb. L. Rev. 1139, 1148 (1981) (racial classification before *Bakke* generally subjected to demanding strict scrutiny test).

[10] *Bakke*, 438 U.S. at 272-75. In cases in which the Court utilized a strict scrutiny analysis, the Court premised the evaluation upon the fact that government had discriminated against minorities. *See* Comment, *supra* note 9, at 1149. However, the plan at issue in *Bakke* discriminated against whites, thus making the application of the previously-adhered-to strict scrutiny standard questionable. *Id.*

[11] *Bakke*, 438 U.S. at 274, 277. The admissions program at the University of California at Davis Medical School consisted of two admissions committees. *Id.* at 273. One was the General Admissions Committee, and the other was the Special Admissions Committee. *Id.* It was the duty of the Special Admissions Committee to select applicants to fill a prescribed 16 place set-aside within the freshman class for minority applicants. *Id.* at 274-75. After making these selections, the General Admission Committee would make final determinations of admittance. *Id.* at 275. White applicants were ineligible for admission under the relaxed standards of the Special Admission Program. *Id.* at 276.

[12] Comment, *supra* note 9, at 1149 n.42.

[13] *Bakke*, 438 U.S. at 276.

[14] *Id.* at 277-78.

Subsequently, the Court, in ruling upon the constitutionality of the challenged race-based admissions program, disappointingly failed to seize upon the opportunity to establish the appropriate level of judicial scrutiny to analyze remedial policies.[15] Instead, the Court held in favor of the white plaintiff Bakke,[16] who was challenging the admissions policy, and directed the University to admit him.[17] Unfortunately, in reaching its decision, the Court divided on the proper level of scrutiny to be accorded "so called benign discrimination"[18] implemented to advance racial equality.[19]

As a direct result of the *Bakke* Court's inability to clearly delineate the constitutionality of racial preferences, "lower courts, program administrators, and legislatures" were unfortunately left without guidance as to formulating and evaluating affirmative action plans which would ultimately pass constitutional muster.[20]

Although the judiciary failed to set forth any measurable constitutional guidelines, government entities relied upon the legislation of the United States Congress, passed the year preceding the *Bakke* decision, which established express racial quotas in the context of federal government public works appropriations. Hence, the affirmative action program initiated by Congress was thereafter used as pattern legislation in instituting and defending the constitutionality of Minority Business Enterprise Set-Asides instituted at various governmental levels throughout this country.[21]

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[15] *See* Comment, *supra* note 9, at 1149 (Court unable to agree on level of scrutiny applied affirmative action program). Of the nine justices reviewing the case, one used strict scrutiny; four did not consider the constitutional question at all; and four would have upheld the program by applying a middle level test. *Id.* at 1152.

[16] *Bakke*, 438 U.S. at 320. Plaintiff, Alan Bakke, was a white male applicant to the Davis Medical School who had been denied admittance, although lesser qualified minority applicants were admitted under the affirmative action policy of the admission committee. *Id.* at 276.

[17] *Id.* at 320. The Court emphasized the state's failure to prove that Mr. Bakke would not have gained admission in the absence of the Special Admissions Program and granted injunctive relief directing his admission. *Id.*

[18] Comment, *supra* note 9, at 1149; *see* G. GUNTHER, CONSTITUTIONAL LAW CASES AND MATERIALS 678 (10th ed. 1980)(a benign discrimination refers to discrimination designed to enhance opportunities available to disadvantaged minorities).

[19] *Bakke*, 438 U.S. at 307; *see* Comment, *supra* note 9, at 1150.

[20] Comment, *supra* note 9, at 1151. The *Bakke* decision conveyed contradictory signals. *Id.* Although five Justices agreed that preferential affirmative action programs were appropriate in certain instances, they failed to reach a consensus on either the governmental objectives needed to justify such a program, or the constitutional requirements which must be accorded appropriate deference in instituting such a plan. *Id.*

[21] *See infra* note 49. The challenged language in the Richmond set-aside is identical

II. The Public Works Employment Act of 1977

In 1977, Congress enacted the Public Works Employment Act (PWEA),[22] which was designed to inflate a depressed American economy by making available four billion dollars in federal funds to state and local governments for public works projects. The Act allocated ten percent of the funds appropriated to business enterprises owned by United States citizens who were "[n]egroes, Spanish-speaking, Orientals, Indians, Eskimos and Aleuts."[23] Notably, this provision constituted the federal government's first attempt to utilize express racial quotas in the administration of public work contracts.[24]

To facilitate implementation of the act, the Economic Development Administration (EDA)[25] issued guidelines governing minority business participation in the public works grants issued pursuant to the act. The guidelines provided that "the primary obligation for carrying out the ten percent minority business enterprise participation requirement rests with EDA Grantees."[26] The obligation could be ful-

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to the racial preference defined in Congress' public works legislation. *Id.*

[22] Pub. L. No. 95-28, 91 Stat. 116 (1977) (codified at 42 U.S.C. §§ 6701-6710 (1982). The PWEA was an amendment to the Local Public Works Capital Development and Investment Act of 1976, which directed the Secretary of Commerce, through the Economic Development Administration, to make grants to state and local governments for the total costs of public works projects. H.R. Rep. No. 20, 95th Cong., 1st Sess. 3-4 (1976).

[23] 42 U.S.C. §§ 6701-6710. The minority business enterprise provision of the Public Works Employment Act of 1977 states, as follows:

> Except to the extent that the Secretary determines otherwise, no grant shall be made under this chapter for any local public works project unless the applicant gives satisfactory assurance to the Secretary that *at least 10 per centum* of the amount of each grant *shall be expended for minority business enterprises*. For purposes of this paragraph, the term "minority business enterprise" means a business at least 50 per centum of which is owned by minority group members or, in case of a publicly owned business, at least 51 per centum of the stock of which is owned by minority group members. . . . [M]inority group members are citizens of the United States who are Negroes, Spanish-speaking, Orientals, Indians, Eskimos, and Aleuts.

Id. § 6705(f)(2) (emphasis added).

[24] Days, Fullilove, 96 Yale L.J. 453, 453 (1987).

[25] Economic Development Admin., U.S. Dep't of Commerce, Guideline for 10% Minority Business Participation in Local Public Works Grants (1977) [hereinafter EDA Guidelines].

[26] *Id.* at 2-7.

> The primary obligation for carrying out the 10% MBE participation requirement rests with EDA Grantees . . . [T]he Grantee and those of its contractors which will make subcontracts or purchase substantial supplies from other firms must seek out all available bona fide MBE's and make every effort to use as

filled via the grantee's own prime contracts, or through the subcontracts or supply contracts of the grantee's prime contracts.[27]

These guidelines recognized that a grantee might encounter unavoidable difficulty in adhering to the ten percent set-aside provision of the act if there were no qualified minority business enterprises within the project area or location. In lieu thereof, a grantee could "apply for a waiver before requesting bids on a project if it could be shown there were no relevant, available, qualified minority business enterprises which could reasonably be expected to furnish services or supply materials for the project."[28]

Three years subsequent to the enactment of PWEA,[29] Congress' remedial legislation was constitutionally challenged. In *Fullilove v. Klutznick*,[30] opponents of race-conscious affirmative action plans chal-

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many of them as possible on the project.

Id. See generally Days, *supra* note 24, at 465 (guidelines for carrying out minority business enterprise participation requirement).

[27] *See* Days, *supra* note 24, at 465.

[28] *Id.*; *see* ECONOMIC DEV. ADMIN., U.S. DEP'T. OF COMMERCE, LOCAL PUBLIC WORKS PROGRAM, ROUND II, GUIDELINES FOR 10% MINORITY BUSINESS PARTICIPATION IN LPW GRANTS 13-15 (1978). Specifically, the guidelines made the following pertinent waiver provisions:

> EDA will only approve a waiver under exceptional circumstances. The Grantee must demonstrate that there are not sufficient relevant, qualified minority business enterprises whose market areas include the project location to justify a waiver. The Grantee must detail in its waiver request the efforts the Grantee and potential contractors have exerted to locate and enlist MBE's. The request must indicate the specific MBE's which were contacted and the reasons each MBE was not used. . . . Only the Grantee can request a waiver . . . .

Id.

[29] *See supra* notes 21-24 and accompanying text.

[30] 448 U.S. 448 (1980). Prior to the Supreme Court's influential *Fullilove* decision, the MBE requirement of the PWEA was subjected to numerous constitutional challenges. Comment, *supra* note 9, at 1141; *see* Rhode Island Chapter, Associated Gen. Contractors of Am., Inc. v. Kreps, 450 F. Supp. 338, 357 (D.R.I. 1978) (upholding constitutional validity of government set-aside); Ohio Contractors Ass'n v. Economic Dev. Admin., 452 F. Supp. 1013, 1021 (S.D. Ohio 1977) (same); Constructors Assoc. v. Kreps, 441 F. Supp. 936, 939 (W.D. Pa. 1977) (same). *But see* Montana Contractors' Ass'n v. Secretary of Commerce, 460 F. Supp. 1174, 1177 (D. Mont. 1978) (holding set-aside provision unconstitutional); Associated Gen. Contractors v. Secretary of Commerce, 459 F. Supp. 766, 780 (C.D. Cal. 1978) (same); Associated Gen. Contractors v. Secretary of Commerce, 441 F. Supp. 955, 963 (C.D. Cal. 1977)(same); Wright Farms Constr., Inc. v. Kreps, 444 F. Supp. 1023, 1032 (D. Vt. 1977) (same). More importantly, prior to the Supreme Court's *Fullilove* decision, only two of the Supreme Court's modern cases had validated the constitutionality of racial classifications. *See* Korematsu v. United States, 323 U.S. 214, 219 (1944) (upholding exclusion order of all persons of Japanese ancestry); Hirabayashi v. United States, 320 U.S. 81, 102 (1943) (curfew order promulgated to per-

lenged the Act alleging it violated the equal protection clause of the Constitution of the United States.[31] In unequivocally upholding the act as constitutional, the Supreme Court pronounced the legislation to be within the power of Congress to provide for the general welfare of the United States.[32] Accordingly, the Court held that the equal protection clause did not bar adoption of race-conscious measures aimed at terminating the perpetual effect of racial discrimination.[33]

Although the *Fullilove* decision strongly emphasized that the Court was reviewing an act implemented by Congress,[34] numerous state and lower federal courts interpreted the language of the opinion as authorizing the creation of non-federal minority set-asides. "Consequently . . . states, state agencies, counties, municipalities, and municipal agencies . . . patterned programs after the Public Works Employment Act in an effort to benefit minority enterprises."[35] In accord with

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sons of Japanese ancestry during time of war unconstitutional).

[31] *Fullilove*, 448 U.S. at 455. Petitioners, consisting of several associations of contractors, alleged that enforcement of the 10% MBE requirement perpetuated an economic injury to them and that on its face, the set-aside provision violated the equal protection clause of the fourteenth amendment. *Id.* For a thorough equal protection analysis of the constitutionality of MBE set-asides, see Comment, *supra* note 9, at 1142.

[32] *Fullilove*, 448 U.S. at 472. In rejecting petitioners' arguments of constitutional invalidity pursuant to the equal protection clause, Chief Justice Burger, writing for the plurality, noted that although racial classifications require thorough examination, the judiciary must accord appropriate deference to Congress, a co-equal branch of the United States Government charged by the Constitution with the power to provide for the general welfare of the United States and to enforce by legislative enactment the equal protection guarantees of the fourteenth amendment. *Id.*; *see* Katzenbach v. Morgan, 384 U.S. 641, 651 (1966) ("Correctly viewed, § 5 of the Fourteenth Amendment is a positive grant of legislative power authorizing Congress to exercise its discretion in determining whether and what legislation is needed to secure the guarantees of the Fourteenth Amendment."); *see also* South Carolina v. Katzenbach, 383 U.S. 301, 326 (1966) (Congress has broad legislative powers under the Constitution).

[33] *Fullilove*, 448 U.S. at 478. The *Fullilove* decision, although affirmatively answering the question of whether the federal government can appropriately consider race in awarding federal construction contracts, left a host of other important questions unanswered. Comment, *Federal Efforts to Assist Minority Construction Contractors: The Need for Comprehensive Planning*, 14 U.C. DAVIS L. REV. 125, 129 (1980). Subsequently, commentators pondered the scope of the decision. *Id.* at 150. Some argued that the ruling only accorded constitutional protection to certain federal statutes while others considered the lack of substantive evidence presented by Congress supporting the need for such legislation and contended that the decision would be granted broader application. *See generally* Comment, *supra*, at 149-50 (discussing interpretation to be accorded *Fullilove* decision).

[34] *Fullilove*, 448 U.S. at 483.

[35] Days, *supra* note 24, at 454; *see* MINORITY BUSINESS DEVELOPMENT LEGAL DEFENSE AND EDUCATION FUND, REPORT ON THE MINORITY BUSINESS ENTERPRISE PROGRAMS OF

the *Fullilove* decision, government-implemented minority set-asides were rarely defeated on equal protection grounds[36] and therefore enjoyed virtually uninhibited growth at all governmental levels. This uninhibited growth was curtailed by the Supreme Court's decision in *Wygant v. Jackson Board of Education*,[37] which struck down a local school board's layoff protection plan for minority teachers on equal protection grounds. As expected, the striking down of the racially protective measure[38] prompted a host of new constitutional challenges to state and local minority business enterprise set-asides.[39]

The matter receiving judicial evaluation in *Wygant* pertained to the constitutional validity of a collective bargaining agreement that extended layoff protection to minority teachers originally hired under affirmative action plans.[40] The challenged agreement was conceived in an

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STATE AND LOCAL GOVERNMENTS 2 (1988) (stating at least 32 states and 160 local governments currently have minority business enterprise set-aside programs for public contracting); *see also* U.S. CONFERENCE OF MAYORS & U.S. DEPT. OF COMMERCE, 1986 NATIONAL CITY PROFILES: REPORT ON MINORITY ENTERPRISE DEVELOPMENT PROGRAMS I (MBE assistance programs found in 120 out of 320 mid-sized cities that responded to questionnaires). As an illustration of the post-*Fullilove* set-aside programs enacted at various governmental levels, one merely needs to peruse the broad vernacular of the Richmond provision at issue in *J.A. Croson Co. Infra* note 48 and accompanying text. In that provision, minorities are defined in language identical to that found in the all-encompassing prescribed definition of the PWEA of 1977. RICHMOND VA. CITY CODE § 12-156(a) (1985). To compare the locally instituted set-aside with the federally enacted MBE provision, see *supra* note 23; *infra* note 49.

[36] *See* South Fla. Chapter of the Associated Gen. Contractors v. Metropolitan Dade County, 723 F.2d 846, 856 (11th Cir.), *cert. denied*, 469 U.S. 871 (1984) (county kept within restrictions of equal protection clause as set out in *Fullilove* in enacting challenged set-aside program); Ohio Contractors Ass'n v. Keip, 713 F.2d 167, 173 (6th Cir. 1983) (within power of state to require non-minority contractor to assume reasonable burden of remedying past discrimination). *But see* Arrington v. Associated Gen. Contractors of Am., 403 So. 2d 893, 902-03 (Ala. 1981) (rejecting set-aside on equal protection grounds by distinguishing congressional power seized upon in *Fullilove*).

[37] 476 U.S. 267 (1986).

[38] *Wygant*, 476 U.S. at 284.

[39] *See, e.g.*, Michigan Road Builders Ass'n v. Milliken, 834 F.2d 583, 589 (6th Cir. 1987) (state set-aside invalidated on equal protection grounds in light of Supreme Court's mandate in *Wygant*); Associated Gen. Contractors v. City of San Francisco, 813 F.2d 922, 937-38 (9th Cir. 1987) (city was not justified in turning to such drastic remedial legislation or bid preferences and set-asides); J. Edinger & Son, Inc. v. City of Louisville, 802 F.2d 213, 216 (6th Cir. 1986) (set-asides premised on general population statistics cannot withstand equal protection challenge). For additional references regarding set-asides which have been the subject of litigation, see Days, *supra* note 24, at 454 n.10.

[40] *Wygant*, 476 U.S. at 270-84. The challenged racial classification at issue in *Wygant* correlated the layoff of minority teachers in the school district to the percentage of minority students enrolled in same. *Id.* The racial preference devices were implemented

effort to maintain integration and ease violent racial tension in the county school system.[41] In declaring the plan unconstitutional, the Court, in a plurality opinion, concluded that the use of any racially classified remedy must be supported by some showing of actual past governmental discrimination as opposed to a showing of mere past societal discrimination.[42] Furthermore, the Court determined that an affirmative action plan which resulted in administering any type of racial favoritism must be predicated on a "strong basis in evidence."[43] The proof requires more than merely showing a disparity between the percentage of minorities employed and the percentage in the general population.[44] To fulfill the requisite showing, a successful plaintiff must prove a statistical disparity between the percentage of minorities employed and the percentage in the relevant labor pool.[45] Finally, the *Wygant* Court held that, in addition to the aforementioned showing, racially oriented legislation must be "narrowly tailored" to the remedial objective desired in order to survive constitutional scrutiny.[46]

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and justified by the proponents of the plan by directing attention to the "role model theory." *Id.* at 272. The logic supporting their theory emphasized the importance of attenuating the lingering effects of past societal discrimination via providing minority students with a sufficient number of "role model" figures. *Id.* at 274.

[41] *Id.* at 270.

[42] *Id.* at 276. In determining that proof of past general racial discrimination alone was not a sufficient basis for race-conscious classification, the *Wygant* plurality authored by Justice Powell reasoned that, "[s]ocietal discrimination without more, is too amorphous a basis for imposing a racially classified remedy." *Id.* (quoting University of California Regents v. Bakke, 438 U.S. 265, 307 (1977)).

[43] *Id.* at 277. Although the plurality agreed that governmental use of racial classifications must be premised upon a strong evidentiary basis, they failed to reach a consensus as to what proof was actually needed to uphold an affirmative action plan, thus leading to subsequent confusion in applying the standard. *See generally* Note, *The Nonperpetuation of Discrimination in Public Contracting: A Justification for State and Local Minority Business Set-Asides After* Wygant, 101 HARV. L. REV. 1797, 1800-01 (1988) (governmental use of benign racial classification must be predicated on "strong" or "firm" evidentiary basis).

[44] *Wygant*, 476 U.S. at 274-75. In determining the school board's reliance upon statistical disparities between the number of minorities in the teaching profession and the minority student population within the city to be misplaced, the Court emphasized the numerous possible explanations for the disparity, many of which could in no way be related to discrimination of any type. *Id.* at 276; *see* Hazelwood School Dist. v. United States, 433 U.S. 299, 308 n.13 (1977) (when in need of qualified personnel, general population comparisons have little probative value).

[45] *Wygant*, 476 U.S. at 274-75; *see* Mayor v. Educational Equality League, 415 U.S. 605, 620 (1974) (cannot assume all citizens of particular class possess necessary qualifications for purpose of determining unlawful exclusion of specific class members).

[46] *Wygant*, 476 U.S. at 278-84.

Although the *Wygant* decision was not per se concerned with minority set-aside programs, in actuality the decision had a far-reaching effect upon the survival of remedial programs. For instance, lower courts consistently relied upon the decision to invalidate MBE set-asides by concluding that mere statistical disparities between the percentages of MBE's participating in public contracting and the percentage of minorities in a given locality did not constitute a sufficient justification for implementing set-aside programs.[47]

As a direct result of the apparent post-*Wygant* confusion in regard to interpreting the constitutional validity of locally instituted set-asides, the Supreme Court, in the recent decision of *City of Richmond v. J.A. Croson Co.*,[48] clarified the appropriate judicial deference to be accorded such remedial MBE set-aside programs. Under the plan at issue in *Croson*, companies contracting with the City of Richmond, Virginia, were required to subcontract at least thirty percent of the dollar value of each contract to a minority business enterprise, subject to a waiver upon a showing of exceptional circumstances.[49] Additionally, the thirty percent set-aside requirement applied only to non-minority owned prime contractors, thus effectively excluding minority-owned prime contractors from having to comply with the set-aside provisions of the plan.[50]

In determining the constitutional validity of Richmond's MBE set-aside, the Supreme Court first addressed the merits of the *Fullilove* decision as applied to state and locally instituted set-aside programs.[51] In so doing, the *Croson* majority immediately focused upon the language of Justice Burger's principal opinion in *Fullilove*, which unam-

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[47] *See supra* note 22; *see also* H.K. Porter Co. v. Metropolitan Dade County, 825 F.2d 324, 331 (11th Cir. 1987) (citing *Wygant* to distinguish societal discrimination from discrimination which is attributable to governmental action).

[48] 109 S. Ct. 706 (1989).

[49] *See* RICHMOND, VA. CITY CODE, § 12-156(a) (1985) (setting forth provisions of Minority Business Utilization Plan enacted in 1983 by City of Richmond, Virginia). Under the plan, at least 30% of the dollar value of the city's construction expenditures was to be procured for minority subcontractors, unless the prime contractor was minority owned. *Id.* The plan defined a minority-owned business as "[a] business at least fifty-one (51) percent . . . owned and controlled . . . by minority group members." *Id.* Minority group members were defined as "[c]itizens of the United States who are Blacks, Spanish-speaking, Orientals, Indians, Eskimos, or Aleuts." *Id.* The set-aside plan was to be effective until 1988, at which time renewal was within the discretion of the City Council. *Id.* Failure on the part of a non-minority prime contractor to adhere to the 30% set-aside provision, absent a waiver, could result in suspension or termination of the contract. *Id.*

[50] *Croson*, 109 S. Ct. at 713. The 30% set-aside was not applicable to city contracts awarded minority-owned prime contractors. *Id.*

[51] *Id.* at 717.

biguously stressed one essential factor in upholding the congressionally enacted set-aside,[52] such being the "unique remedial power" possessed by the Congress of the United States pursuant to section five of the fourteenth amendment.[53] Hence the *Croson* Court effectively distinguished the minority advancement plan upheld in *Fullilove* from the Richmond set-aside by showing that the validity of the set-aside enacted under the Public Works Employment Act (PWEA) was predicated upon an analysis of the constitutionality of congressionally enacted legislation.[54] Accordingly, the judicial deference granted the *Fullilove* set-aside was determined unpersuasive in the context of state or local remedial programs.[55]

After determining *Fullilove* uncontrolling as pertaining to remedial measures implemented at the state or local level, the Court shifted its attention to an equal protection analysis.[56] In so doing, the Court

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[52] *Id.* at 718; *see* Fullilove v. Klutznick, 448 U.S. 448, 483-88 (1980) (emphasizing unique remedial powers of Congress and flexible nature of set-aside in upholding 10% set-aside provision).

[53] *Croson*, 109 S. Ct. at 718. In emphasizing the broad powers of Congress to enact remedial legislation, Justice O'Connor reiterated Justice Burger's statement: "Here we deal . . . with the broad remedial powers of Congress. It is fundamental that in no organ of government, state or federal, does there repose a more comprehensive remedial power than in the Congress, expressly charged by the Constitution . . . to enforce equal protection guarantees." *Id.* (quoting *Fullilove*, 448 U.S. at 483); *see supra* note 32 and accompanying text (general overview of broad legislative powers possessed by Congress). *See generally* Bahrer, Bakke, Weber, *and* Fullilove: *Benign Discrimination and Congressional Power to Enforce the Fourteenth Amendment*, 56 IND. L.J. 473, 512-13 (1981) ("Congress may authorize, pursuant to section 5, state action that would be foreclosed to the states acting alone"); Days, *supra* note 24, at 474 ("*Fullilove* clearly focused on the constitutionality of a congressionally mandated set-aside program").

[54] *See supra* notes 48-49 and accompanying text.

[55] *Croson*, 109 S. Ct. at 719. The Court noted that just because Congress can "identify" and "redress" the effects of societal discrimination, this did not mean that states and their political subdivisions are free to implement such race-conscious remedies without being subject to the constraints of § 1 of the fourteenth amendment. *Id.* The Court reasoned that a contrary ruling would effectively place the 50 state legislatures and their various political subdivisions in control of the fourteenth amendment, a result which the Court frowned upon as being subversive to the intent of the amendment's founders. *Id.* The founders had intended to limit a state's use of race as a criterion for legislative action. *Id. See generally* Associated Gen. Contractors v. City of San Francisco, 813 F.2d 922, 929 (9th Cir. 1987) (Kazinski, J.) (city not equivalent to federal government in establishing justification for race-conscious remedial action).

[56] *Croson*, 109 S. Ct. at 720. The equal protection clause of the fourteenth amendment provides in pertinent part: "No State shall . . . deny to any person within its jurisdiction the equal protection of the laws." U.S. CONST. amend. XIV, § 1. Because the Richmond plan erected race as the sole criterion for qualifying for a fixed percentage of the city's public contracts, pursuant to the interpreted intent of the equal protection

acknowledged that although a state or local government subdivision has the authority, if delegated from the State, to enact remedial legislation aimed at attenuating the effects of private discrimination within its legislative boundaries, such authority must be exercised within the constraints of the fourteenth amendment.[57] Hence, "some showing of prior discrimination by the governmental unit involved" was set forth as a constitutional prerequisite to the implementation of a race-conscious set-aside plan conceived at the local or state level.[58] In accord therewith, the Court reiterated the reasoning employed by Justice Powell, in writing for the *Wygant* plurality, that "societal discrimination" alone is an inadequate basis for "race-conscious classifications" and will not in and of itself adequately support a facially discriminatory set-aside program.[59]

Thereafter, in striking down Richmond's program as unconstitutional, the *Croson* majority directed attention to the fatal weaknesses of the plan.[60] Of primary import to the Court's conclusion was that the findings of the Richmond City Council, which were promulgated in support of the set-aside, were premised upon generalized assertions of past discrimination in the construction industry as a whole. Accordingly, the Court concluded such undocumented generalities provided no guidance or justification for the placement of a racial quota upon the awarding of public contracts.[61] While acknowledging that states

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clause, the Court employed a "strict scrutiny" analysis of the plan in order to ensure the legislative goal sought was legitimate and important enough to warrant the use of a race conscious tool. *Croson*, 109 S. Ct. at 721.

[57] *Croson*, 109 S. Ct. at 720. Justice O'Connor, writing for the majority, determined as previously expressed by Justice Powell in University of California Regents v. Bakke, 438 U.S. 265, 289-90 (1977), that "[t]he guarantee of equal protection cannot mean one thing when applied to one individual and something else when applied to a person of another color." *Croson*, 109 S. Ct. at 721. Thus, as acknowledged by the Court, the constraints of the equal protection clause required that all other legislative weapons be exhausted before resorting to suspect measures to eliminate discrimination against minorities. *Id.*

[58] *Croson*, 109 S. Ct. at 720 (plurality opinion) (quoting *Wygant*, 476 U.S. at 274). After setting forth the requisite showing to be of prior past discrimination, the Court went on to say that with regard to institutional competence, the City of Richmond could as a matter of state law use its spending powers to remedy private discrimination. *Id.* However, in such a case, the discrimination to be eradicated must be shown with the aforementioned specificity in order to comply with the constitutional mandates of the fourteenth amendment. *Id.* at 720.

[59] *Id.* at 723.

[60] *Id.*

[61] *Id.* at 724. The Court reasoned that mere claims of past discrimination within a particular industry, unsupported by specific evidence of discriminatory practices, will not

and their political subdivisions may implement race-conscious relief plans to prevent perpetuating a pattern of prior discrimination, the Court unambiguously concluded that such remedial action could pass constitutional muster only upon a specific identification of the discrimination to be cured.[62] It was decided that such an evidentiary showing must be made because "classifications based on race are potentially so harmful to the entire body politic, [and] it is especially important that the reasons for any such classification be clearly identified and unquestionably legitimate."[63]

With the aforementioned in mind, the *Croson* Court determined the evidence presented by the proponents of the Richmond set-aside insufficient to identify, with any measurable specificity, discrimination within the Richmond construction industry.[64] Therefore, it was concluded that the city failed to establish a compelling justification, as required by the Constitution, for apportioning public contract opportunities on the basis of race.[65] Furthermore, the additional failure on behalf of the city to demonstrate the unavailability of any alternative race-neutral measures, which could have been employed to increase

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justify legislative enactments employing racial quotas. *Id.*

[62] *Id.* at 727; *see* Days, *supra* note 24, at 480-81 (essential that state and local agencies establish presence of discrimination based on their own fact finding processes or upon conclusions reached by other competent institutions).

[63] *Croson*, 109 S. Ct. at 727 (quoting Fullilove v. Klutznick, 448 U.S. 448, 533-35 (1980)). In *Fulilove* Justice Stevens, in cautioning against the general acceptance of racial classification reasoned that our society was committed to the proposition that governmental institutions had a fundamental duty to govern without showing partiality. *Fullilove*, 448 U.S. at 533; *see* Hampton v. Mow Sun Wong, 426 U.S. 88, 100 (1976) ("federal sovereign, like the states, must govern impartially"). Therefore, adhering to the espoused "impartiality principle," Justice Stevens argued that when a government accords different treatment to different persons, a valid and legitimate reason for the disproportionate treatment must be shown. *Fullilove*, 448 U.S. at 533-34.

[64] *Croson*, 109 S. Ct. at 727. In rejecting Richmond's claim that past societal discrimination can serve as the foundation for racial preferences, the Court pointed to the reality that granting merit to such an argument would open the door to "remedial relief" based solely upon unmeasurable claims of previous wrongs. *Id.* Courts would then be required to determine which injuries perpetrated by our society were of such a nature as to entitle the victims of such prior wrongs to preferential classification. *Id.* Such a result would be both unconstitutional and unworkable. *Id.*; *see* University of California Regents v. Bakke, 438 U.S. 265, 296-97 (1977) (judiciary not competent to engage in sociological and political analysis necessary to grant preferential classification based on societal discrimination alone).

[65] *Croson*, 109 S. Ct. at 727. Recognizing the constitutional mandate to identify with reasonable particularity the discrimination to be remedied, the Court concluded that Richmond's history of school segregation and numerous congressional reports were insufficient evidence to support the racially based set-aside. *Id.*

minority business participation in municipal contracting projects, was deemed a violation of the judicial declaration that race-conscious remedies be "narrowly tailored" to achieve the desired objectives.[66] As a result of the foregoing analysis, the Richmond MBE set-aside was declared an unconstitutional assertion of legislative authority.[67]

III. *Croson*'s Impact upon Minority Set-Aside Programs

At first glance, one might interpret the *Croson* decision as a step backwards in regard to the struggle of minorities to become viable members of the mainstream economy.[68] However, it is this author's contention that the ruling will have a positive impetus upon minority business set-asides by revitalizing the integrity of the affirmative action movement.

While many Americans realize race-conscious remedies are necessary in certain instances to achieve the desired objective of equal justice for all, they are increasingly hesitant to allow any use of race merely because proponents of such an approach argue it is the only means of achieving true equality.[69] Accordingly, such sensitivity to ra-

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[66] *Id.* at 728; *see* United States v. Paradise, 480 U.S. 149, 171 (1987) ("[i]n determining whether race-conscious remedies are appropriate, we look to several factors, including . . . the efficacy of alternative remedies . . . ."), Recent decisions, *Constitutional Law—Affirmative Action—Court-Ordered One-Black-for-One-White Promotional Quota Constitutional if Narrowly Tailored to Serve Compelling Governmental Interest*, 57 Miss. L.J. 253, 254-66 (1987)(authored by Karen DeMetz Luster)(discussing development of *Paradise* decision). The Court went on to set forth various alternative measures, which should be considered before enacting a race-conscious set-aside, such as simplification of bidding procedures; relaxation of bonding requirements; and training and financial aid for disadvantaged entrepreneurs of all races. *Croson*, 109 S. Ct. at 729-30.

[67] *Croson*, 109 S. Ct. at 730. As set forth by the Court, the City of Richmond's failure to identify the need for the remedial action implemented in the awarding of its public construction contracts effectively violated the provisions of the equal protection clause. *Id.*

[68] *See* Raspberry, *Minority Contractors Face Task of Establishing Discriminations*, Daily Mississippian, Feb. 15, 1989, at 2 (Supreme Court's decision against Richmond's set-aside program signals trouble on racial justice front). In Mr. Raspberry's opinion, the *Croson* decision's requirement of setting forth specific proof of one's own past bias or discrimination before taking corrective actions, "threaten[ed] a whole range of affirmative-action initiatives." *Id.*

[69] Days, *supra* note 24, at 457; *see* Neuborne, *Observations on* Weber, 54 N.Y.U. L. Rev. 546, 547 (1979) (decisions to allocate goods on basis of race should be suspect). Neuborne, in cautioning against the allocation of goods based on race, enunciated that race should generally be regarded as irrelevant in the market place. *Id.* However, Neuborne did thereafter acknowledge that there are instances when the use of race as a classification for preferential treatment is necessary to "redress the lingering impact of

cial classifications requires that any programs containing racial preferences be implemented only when they represent a focused and informed effort to eradicate the effects of racial discrimination and to prevent its recurrence.[70] Therefore, for an affirmative action set-aside to receive general public acceptance, a satisfactory showing of the following must be made:

> [T]he discriminatory practice has been defined adequately; alternatives short of explicit reliance upon race have been canvassed and found wanting; and any race-conscious remedy has been sufficiently limited in scope and time to address the evil at hand without either eroding legitimate standards or converting an interim minority preference system into a permanent institutionalized fixture.[71]

Prior to the consensus reached in *Croson* as to the appropriate findings necessary to justify an affirmative action set-aside, many state and local governments instituted such remedial programs in a hurried attempt to implement some type of antidiscriminatory action.[72] However, in taking such measures, no efforts were made to identify the problems to be dealt with or to examine the various alternative race-neutral solutions which might have otherwise been available. Such an uninformed and unjustified approach instead of benefiting this country's minority sector, served to impede the general principles underlying the affirmative action movement.[73]

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past racial discrimination." *Id.* at 548. Even so, Neuborne still adhered to his earlier hypothesis that race-based remedies, even though appropriate in certain instances, should be subject to suspect classification. *Id.* at 547.

[70] Days, *supra* note 24, at 460. As alluded to by the author, the uninformed and unjustified implementation of racial classifications may produce serious side effects, such as providing American hate groups, like the Ku Klux Klan, with a viable recruiting and marketing tool. *Id.* at 459. Hence, set-asides instituted without serious forethought may serve to undermine the logic behind the entire equal rights movement. *See* Williams, *Discrimination and Public Policy*, 1 SELECTED AFFIRMATIVE ACTION TOPICS IN EMPLOYMENT AND BUS. SET-ASIDES 9, 18-19 (1985) (unjustified use of quotas may provide fuel for American hate groups).

[71] Days, *supra* note 24, at 457.

[72] *See supra* note 36. In regard to the deference afforded Congress as compared with state and local governments in enacting minority set-asides, see *Fullilove*, 448 U.S. at 478 (Congress has broad constitutional powers to enact remedial legislation directed at racial discrimination); Note, *Constitutional Law—Evidentiary Standards Required to Pass Affirmative Action Legislation*, 61 TEMP. L. REV. 931, 949 (1988) (discussing Congress' broad power to pass affirmative action programs based upon findings of general discrimination).

[73] *See* Days, *supra* note 24, at 459.The general thrust of the affirmative action move-

For instance, a plan of affirmative action which is legislatively enacted in the absence of a careful evaluation of the facts and alternatives may be misguided and fall short of its desired objective, which is to provide assistance to those most deserving of aid, by inadvertently lending assistance to those who are capable of operating without preferential treatment.[74] Furthermore, programs instituted in ignorance may unjustifiably harm others and may operate for longer periods than necessary.[75] Therefore, when a governmental entity, other than Congress,[76] determines an explicit racial classification is necessary, the Constitution, as well as the underlying principles of affirmative action, requires that such action be the product of serious deliberation and evaluation.[77] In accord therewith, the *Croson* decision demands that when governmental action violates the constitutional principle of "color-blindness,"[78] as a minority set-aside does, the government must

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ment is to overcome the effects of racial discrimination by increasing employment and economic opportunities for minority group members. 1 THE OXFORD ENGLISH DICTIONARY 219 (2d ed. 1989).

[74] *See* Comment, *Federal Efforts to Assist Minority Construction Contractors: The Need for Comprehensive Planning*, 14 U.C. DAVIS L. REV. 125, 153 (1980) (solve problem of ensuring set-aside funds go to bona fide MBE's by requiring MBE to purchase certification of legitimacy); *see also* THE COMPTROLLER GEN. REPORT TO THE CONGRESS OF THE UNITED STATES, THE SBA 8(A) PROCUREMENT PROGRAM - A PROMISE UNFULFILLED (April 8, 1981) (minority contracting program has benefited few); U.S. ECONOMIC DEV. ADMIN., U.S. DEP'T OF COMMERCE, INTERIM REP. ON 10 PERCENT MINORITY BUSINESS ENTERPRISE REQUIREMENT 24, 8 (1978) (minority fronts present pervasive problem to MBE's); Bates, *Minority Business Set-Asides: Theory and Practice*, 1 *Selected Affirmative Action Topics in Employment and Bus. Set-Asides* 142, 152-54 (1985) (firms participating in minority set-asides are much larger and more profitable than average minority firm).

[75] *Set Set-Asides Aside*, NEW REPUBLIC, May 5, 1986, at 10-11 (criticizing set-aside programs in lieu of sham minority business enterprises).

[76] For explanation of congressional exception see *supra* notes 30, 48-49, 68 and accompanying text.

[77] *Croson*, 109 S. Ct. at 730; *see* McLaughlin v. Florida, 379 U.S. 184, 190-92 (1964) (when legislative body employs suspect classification, such cannot rely upon generalized assertion of goals sought to be achieved). *But see* Linde, *Due Process of Lawmaking*, 55 NEB. L. REV. 197, 222-44 (1976) (legislature cannot and should not be held to standard of rational lawmaking).

[78] *Croson*, 109 S. Ct. at 730; *see* Plessy v. Ferguson, 163 U.S. 537, 559 (1896) (Harlan, J., dissenting)(majority opinion overruled in Brown v. Board of Educ., 347 U.S. 483 (1954)). This phrase is found in Justice Harlan's dissent from the Court's upholding racial segregation in public transportation. *Id.* at 559. In pertinent part, Justice Harlan stated: "[I]n view of the Constitution . . . there is in this country no superior, dominant, ruling class of citizens. There is no caste here. Our Constitution is color blind . . . ." *Id.* at 559. However, the Congress of the United States need not act in a color-blind manner to remedy past discrimination. *See Fullilove*, 448 U.S. at 482 (rejecting contention that Congress must act in color-blind fashion).

be prepared to demonstrate that it acted upon a complete record with a full understanding of the program's overall implications.[79]

IV. The Future of Minority Set-Asides

This paper has attempted to focus upon the reasoning of the United States Supreme Court in one of its latest affirmative action decisions and the positive ramifications this will have upon affirmative action set-asides.[80] In light of the constitutional requirements enunciated by Justice O'Connor, writing for the *Croson* majority, regarding the implementation of an MBE set-aside at the state or local government level,[81] one might inquire: What effect will the increased evidentiary standard of *Croson* have upon existing, as well as potential, minority entrepreneurs? The answer to this all-important question does not lend itself to a prompt or easy response; however, the author suggests that an answer is contingent upon the actual commitment of state and local governments to the enforcement of civil rights and social justice.

As heretofore set forth, the *Croson* decision affirmatively establishes that racial preferences, such as those in minority set-asides, instituted at the state or local level, will be reviewed with constitutional favor only if such preferences seek to redress harms caused by past illegal discrimination, and such discrimination is sufficiently documented by the governing authority promulgating the preference.[82] Accordingly, an institution lacking federal competence, which desires to address a racial imbalance within its own "bailiwick," but is unable to point to specific acts of past discrimination, must resort to alternative nonpreferential affirmative action efforts[83] in order to withstand the

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[79] *Croson*, 109 S. Ct. at 730. The Supreme Court examined the Richmond set-aside legislation under a quasi "strict scrutiny" standard. *Id.* at 710. Such standard requires that any affirmative action plan have a substantial government interest as well as be narrowly tailored to obtain that substantial interest. Note, *supra* note 68, at 945. Accordingly, the requisite showing can only be made by presenting proof of specific past governmental discrimination and how such a remedial plan is to make whole the parties injured as a result of the identified past discrimination. *See generally*, Days, *supra* note 24, at 484-85.

[80] *Croson*, 109 S. Ct. at 729-30. A restatement of the possible negative implication of the *Croson* decision is unnecessary, since Justice Marshall fully elaborated upon such contingencies in his dissent. *Id.* at 739-40. Justice Marshall stated that the majority's pronouncement "will inevitably discourage or prevent governmental entities, particularly states and localities, from acting to rectify the scourge of past discrimination." *Id.* at 740.

[81] *See supra* notes 58-65 and accompanying text.

[82] *Id.*

[83] *Croson*, 109 S. Ct. at 729-30. Nonpreferential affirmative action includes any type

constitutional analysis of a conservative United States Supreme Court.

Nonpreferential measures such as training, education, counseling, recruitment programs, and financial assistance[84] can be implemented at the local or state level to assist all disadvantaged groups, including, inter alia, Minority Business Enterprises, without being subjected to the equal protection analysis enunciated in *Croson*.[85] Although implementing such race-neutral measures may require greater governmental effort and dedication than the pre-*Croson* minority set-aside, the potential benefits to be received from such increased access efforts and nonpreferential programs are great indeed.[86] For instance, a minority

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of approach taken to remedy past discrimination which does not focus solely upon one's race in creating employment or educational opportunities. Lavinsky, *Affirmative Action: Evaluation of the Past and Strategies for a Better Future*, 1 SELECTED AFF. ACTION TOPICS IN EMPLOYMENT AND BUSINESS SET-ASIDES 320, 325 (1985). Examples of this type of affirmative action include special efforts to recruit qualified minority group members, or the introduction of training and support programs for employees, without regard to whether such programs are of particular assistance to minorities. *Id.* Thus, nonpreferential programs provide various advancement opportunities without invoking a person's race as a prerequisite for participation. *Id.*

[84] *See Opposition to Quotas Expressed by New Civil Rights Commission*, Daily Lab. Rep. (BNA) No. 12, at A-3, (Jan. 19, 1984) (training, education, counseling, and recruitment programs warrant encouragement). In regard to training the disadvantaged, technical services such as providing assistance in becoming qualified or licensed in a particular industry, as well as other technical support services, could provide meaningful advancements to underrepresented minorities. Similarly, financial assistance programs could greatly enhance the number of viable minority business enterprises considering the financial barriers which minority entrepreneurs often find themselves confronting. Furthermore, educational training in the form of direct educational grants and work-study programs would assist present and future disadvantaged business entrepreneurs in acquiring the skills needed to operate a business successfully. *See* Kilgore, *Minority and Women's Business Set-Asides: An Appropriate Affirmative Action Response to Discrimination*, 1 SELECTED AFF. ACTION TOPICS IN EMPLOYMENT AND BUSINESS SET-ASIDES 130, 139-41 (1985)(complete and thorough discussion of aforementioned nonpreferential affirmative action measures).

[85] *See supra* notes 52-63 and accompanying text. In view of the Supreme Court's recent decision in Martin v. Wilks, 109 S. Ct. 2180 (1989), the fact that nonpreferential measures will not be subjected to the rigorous equal protection analysis of the Rehnquist Court greatly enhances the overall desirability of taking the nonpreferential route. This is in recognition of the *Martin* Court's decision to allow white fire fighters, who were not parties to an earlier court ordered consent decree, to challenge the constitutionality of the preferential remedial program instituted pursuant to the order of such consent decree. *Id.* at 2188. Thus, considering the vulnerability of preferential quotas to subsequent constitutional attack, nonpreferential measures should appear even more attractive to employers.

[86] *Croson*, 109 S. Ct. at 229-30. For instance, many black contractors confront economic failure simply because they are not knowledgeable with regard to successful bidding procedures. *Id.* Therefore, nonpreferential government assistance programs, such as

contractor's overall job performance will be enhanced through increased access to desperately needed operating capital.[87] Additionally, such programs would provide minorities with technical assistance in developing managerial skills,[88] which in turn will enable them to compete more effectively for government business while maintaining the spirit and integrity of the free enterprise system.[89] Furthermore, nonpreferential assistance to disadvantaged groups will attenuate the "demoralizing effects of a two-tiered work place composed of 'merit' employees and 'quota' employees."[90] Accordingly, when actual past discrimination cannot be proved with the required *Croson* specificity, the implementation of nonpreferential affirmative action programs should prove beneficial to minorities, as well as society in general, by moving toward establishing a society where race is truly irrelevant to the enjoyment of civil rights and liberties.

V. Conclusion

Upon final analysis, no state or local government entity has been prohibited from passing affirmative action programs;[91] however, the evidence of the discrimination to be remedied and the government's justification and documentation of such discrimination, will determine whether affirmative action of a preferential or nonpreferential nature is appropriate.[92] Therefore, the ultimate impact of *Croson*'s increased ev-

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providing some sort of financial and technical assistance to disadvantaged enterprises, could definitely enhance the longevity of the minority contractor. *Id.* at 230.

[87] Lavinsky, *supra* note 83, at 329.

[88] Kilgore, *supra* note 84, at 140.

[89] For a discussion of the monopolistic implications of preferential set-asides, see Sroka, *supra* note 4, at 97.

[90] Lavinsky, *supra* note 83, at 329; *see Senate Committee Hears Views of Academics on Affirmative Action.* Daily Lab. Rep. (BNA) No. 117, at A-9, A-10 (June 18, 1981) (imposition of set-asides and quotas damage minorities' motivation, self-respect, and capacity); *Civil Rights Commission Draws the Line at Quotas, Staff Director Chavez Says,* Daily Lab. Rep. (BNA) No. 194, at A-7 (Oct. 5, 1984) (set-asides opposed by most Americans, including blacks).

[91] *Croson,* 109 S. Ct. at 729. The Court announced: "Nothing we say today precludes a state or local entity from taking action to rectify the effects of identified discrimination within its jurisdiction." *Id.*; *see supra* note 54.

[92] *See supra* note 54. Illustrative of the *Croson* standard was the recent decision promulgated by the Georgia Supreme Court in American Subcontractors Ass'n, Ga. Chapter, Inc. v. City of Atlanta, 376 S.E.2d 662 (Ga. 1989). In this case, Atlanta's Minority and Female Business Participation Program (MFBE) was invalidated pursuant to the equal protection clause of the Georgia Constitution, which provides that "[p]rotection to personal property is the paramount duty of government and shall be impartial and complete. No person shall be denied the equal protection of the laws." *Id.* at 663-64; *see* Ga.

identiary standard upon the minority community, as evidenced by post-*Croson* decisions,[93] will depend upon the actual commitment of local and/or state governments to minority economic viability. If such governments wish to facilitate minority economic expansion through the use of nonpreferential measures, then minorities should actually benefit from the *Croson* decision.[94] However, if such governments decide preferential affirmative action is the only appropriate solution, minorities may experience some detriment pursuant to the *Croson* analysis.[95] In regard to the aforementioned possibility, the author does not foresee that such a bury-your-head-in-the-sand approach will be taken by government entities, considering the national move to eradicate the lingering effects of a previously racially segregated society.[96]

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CONST. art. 1, § 1, ¶ 2. In determining Atlanta's preferential set-aside to be unconstitutional, the court affirmatively adhered to the constitutional standard of review enunciated by the *Croson* majority. *American Subcontractors Ass'n.*, 376 S.E.2d at 665-66. Accordingly, the court concluded that Atlanta's failure to present a strong evidentiary justification for the race-conscious remedial action, in addition to the fact that the challenged MFBE was not "narrowly tailored" to remedy prior discrimination, necessitated invalidation of the controversial program. *Id.* at 666. In regard to the court's determination that the MFBE set-aside was not sufficiently "narrowly-tailored," the court was tremendously influenced by the testimony of two of Atlanta's key witnesses, in which it was conceded that alternative nonpreferential solutions were available to Atlanta which would accomplish the same desired remedial objectives as the MFBE plan. *Id.* Thus, as previously alluded to, the court employed a strict interpretation of the *Croson* decision and in accord therewith, struck down Atlanta's preferential affirmative action program as being violative of the rights of equal protection as guaranteed to all citizens under the Georgia Constitution. *Id.* at 667; *see* Milwaukee County Pavers Ass'n v. Fiedler, 707 F. Supp. 1016, *modified*, 710 F. Supp. 1532 (W.D. Wis. 1989) (awarding preliminary injunction against Wisconsin construction contract set-aside program in absence of specific evidence of past discrimination in view of *Croson* evidentiary requirements).

[93] *See supra* note 92.

[94] *See* Kilgore, *supra* note 84, at 139-40.

[95] *See, e.g.*, *Croson*, 109 S. Ct. at 752, 757 (Marshall, J., dissenting) (criticizing majority opinion as "cramped vision of Equal Protection Clause" which perpetrated grave disservice upon victims of past and present racial discrimination).

[96] *See* Perlmutter, *Testimony of Anti-Defamation League of B'nai B'rith*, 1 *Selected Affirmative Action Topics in Employment and Bus. Set-Asides* 193, 201 (1985) (society is endeavoring to rid itself of racial discrimination). Illustrative of the author's contention that local governments will endeavor to institute nonpreferential programs is the race-neutral or nonpreferential assistance program recently enacted in Atlanta, Georgia, designed to assist the economically underprivileged. This program, allocating $500,000 in assistance, was enacted after Atlanta's affirmative action plan was deemed unconstitutional. *See* Coleman, *New Rules for Civil Rights*, 75 A.B.A. J. 78, 78 (1989) (Atlanta institutes race-neutral program to replace unconstitutional affirmative action plan).

COMMERCIAL ALCOHOL VENDOR LIABILITY IN MISSISSIPPI: IS THE PARTY OVER?

Introduction

In recent years, a great deal of public interest[1] has focused on injuries and deaths caused by alcohol-related accidents.[2] One response has been for state legislatures to enact, and the police to enforce, tougher DUI laws.[3] Another response, however, has been in the area of civil law. This response is to hold commercial sellers of alcohol liable to persons who are injured or to representatives of persons who have been killed because alcohol has been served to certain classes of persons.[4] This liability of commercial alcohol vendors is the subject of this comment.

This comment will begin with a general discussion of the development of alcohol vendor liability, covering the traditional common-law view of no liability[5] and the subsequent development of liability based on dram shop acts[6] and alcoholic beverage control acts.[7] The effect of Mississippi's relevant alcoholic beverage control statutes will then be examined.[8] A discussion of the few Mississippi cases dealing with alcohol vendor liability will follow, and one will see how Mississippi courts, and in one instance the federal courts, interpret these statutes.[9] A con-

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[1] Awareness of the dangers of drunk driving is largely due to organizations such as Mothers Against Drunk Driving (MADD), Students Against Drunk Driving (SADD), and Remove Intoxicated Drivers (RID). Comment, *Server v. Driver Liability: A Suggested Change To Reduce Drinking and Driving*, 7 N. Ill. U.L. Rev. 257, 257 (1987).

[2] The Presidential Commission on Drunk Driving, established in 1982, found that at least 50% of all highway deaths involved alcohol use, with an annual economic loss estimated at $21 billion. Presidential Commission on Drunk Driving, Final Report: The New Hope of Solution 1 (1983).

[3] Many states reacted to increasing automobile accidents involving alcohol by raising fines, lengthening jail terms and revoking drivers' licenses. Winter, *States Get Tougher on Drunk Drivers*, 68 A.B.A. J. 140, 140 (1982).

[4] *See* 48A C.J.S. *Intoxicating Liquors* § 428 (1981) (modern rule allowing recovery by third parties against commercial vendors); *see also* Comment, *Dramshop Liability: Should the Intoxicated Person Recover for His Own Injuries?*, 48 Ohio St. L.J. 227, 230 & n.32 (1987) (listing states which have allowed recovery by intoxicated persons).

[5] *See infra* notes 12-15 and accompanying text.

[6] *See infra* notes 16-19 and accompanying text.

[7] *See infra* notes 20-28 and accompanying text.

[8] *See infra* notes 29-43 and accompanying text.

[9] *See infra* notes 44-99 and accompanying text.

sideration of problems associated with the statutes and court interpretations[10] will precede the conclusion.[11]

I. General Background

A. Traditional Common Law

At common law, a person who furnished alcohol to the one who consumed it was not liable to the consumer for his injuries from his intoxication, or, in the absence of statutory authority, to a third party who was injured by the intoxicated consumer.[12] This rule of non-liability was based on the premise that the proximate cause of these injuries was the consumption of the liquor, not the furnishing of it.[13] The traditional common-law rule[14] also refused to allow civil actions for the violation of a criminal statute prohibiting the sale of alcohol to certain classes of persons, such as habitual drunkards, intoxicated persons, or minors.[15]

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[10] *See infra* text accompanying notes 100-05; 106-30 and accompanying text.

[11] *See infra* notes 131-34 and accompanying text.

[12] 45 Am. Jur. 2d *Intoxicating Liquors* § 553 (1969). At common law, to give or serve an able-bodied man alcoholic beverages was not an actionable wrong. *See, e.g.*, State *ex rel.* Joyce v. Hatfield, 197 Md. 249, 78 A.2d 754, 756 (1951) (no cause of action when plaintiff brought wrongful death action against tavern owner for negligence of intoxicated minor patron).

[13] *See, e.g.*, Keaton v. Kroger Co., 143 Ga. App. 23, 237 S.E.2d 443, 445-46 (1977) (statute making supply of liquors to minors illegal does not afford basis for civil recovery where common law holds consumption, rather than serving, as proximate cause of injuries); 48A C.J.S., *supra* note 4 (no common-law liability of sellers of intoxicating beverages to minors).

[14] Currently at least seven states adhere to the traditional common-law rule of non-liability: Arkansas, Carr v. Turner, 238 Ark. 889, 385 S.W.2d 656 (1965); California, Cal. Bus. & Prof. Code § 25602 (West 1985) and Cal. Civ. Code § 1714 (West 1985) (abrogation of common-law liability); Delaware, Wright v. Moffitt, 437 A.2d 554 (Del. 1981); Kansas, Ling v. Jan's Liquors, 237 Kan. 629, 703 P.2d 731 (1985); Maryland, Fisher v. O'Connor's, Inc., 53 Md. App. 338, 452 A.2d 1313 (1982); Nebraska, Holmes v. Circo, 196 Neb. 496, 244 N.W.2d 65 (1976); Nevada, Hamm v. Carson City Nugget, Inc., 85 Nev. 99, 450 P.2d 358 (1969). An increasing number of jurisdictions, however, allow recovery on principles of common-law negligence. *See* Buchanan v. Merger Enters., Inc., 463 So. 2d 121, 128 (Ala. 1984) (recognition of common-law action apart from statute); Alegria v. Payonk, 101 Idaho 617, 619 P.2d 135, 138-39 (1980) (recognition of sale of intoxicants as proximate cause of injury to third persons); Mason v. Roberts, 33 Ohio St. 2d 29, 294 N.E.2d 884, 888 (1973) (allowing negligence action despite inapplicability of statute); Halligan v. Pupo, 37 Wash. App. 84, 678 P.2d 1295, 1297-98 (1984) (liability of furnisher of alcohol for damages to third party).

[15] 45 Am. Jur. 2d, *supra* note 12, § 555.

B. Dram Shop Acts

To correct the deficiency of the common law, in the mid-nineteenth century states began to place civil liability on vendors of alcohol for the results of their customers' intoxication through the enactment of "dram shop acts," or "civil damage acts."[16] The remedies available through these statutes are not common-law negligence actions, but are new, separate and distinct rights of action.[17] An important point to remember is that the right and remedy created by these acts are usually exclusive.[18] In other words, no right of action has traditionally existed except that set out in the statutes, and the remedy is not usually expanded except by further legislative action.[19]

C. Alcoholic Beverage Control Acts

As society began to focus more and more attention on drunk driving, courts began to hold that causes of action for civil damages existed even in the absence of dram shop acts, or civil damage laws. Liability was based on violations of alcoholic beverage control acts, which are criminal laws that generally prohibit the furnishing of alcohol to minors, visibly intoxicated persons, and habitual drunkards.[20]

These decisions are frequently referred to by the courts as common-law negligence actions, but they are not actually based on pure negligence principles. They come from the theory that alcoholic beverage control statutes create a duty on the part of alcohol vendors to

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[16] Note, *Social Host Liability for Furnishing Liquor—Finding a Basis for Recovery in Kentucky*, 3 N. KY. L. REV. 229, 231 (1976). The reason for early dram shop acts was to further the temperance movement rather than to curb drunk driving. *Id.* "Dram-shop" has been defined as a "drinking establishment where liquors are sold to be drunk on the premises." BLACK'S LAW DICTIONARY 444 (5th ed. 1979).

[17] 45 AM. JUR. 2d, *supra* note 12, § 561.

[18] *Id. But see* Mason v. Roberts, 33 Ohio St. 2d 29, 294 N.E.2d 884, 887 (1973)(recovery not limited to situations covered by dram shop act).

[19] 45 AM JUR. 2d, *supra*, note 12, § 561. For examples of dram shop acts, see ALA. CODE § 6-5-71 (1975); CONN. GEN. STAT. ANN. § 30-102 (West 1985); GA. CODE ANN. § 3-3-22 (1982); Ill. REV. STAT. ch. 43, para. 135 (1985); IOWA CODE ANN. § 123.92 (West Supp. 1984); ME. REV. STAT. ANN. tit. 28-A § 2504 (1988); MICH. COMP. LAWS ANN. § 436.22 (West 1978 & Supp. 1989); MINN. STAT. ANN. § 340.94 (West Supp. 1985); N.Y. GEN. OBLIG. LAW § 11-101 (McKinney Supp. 1987); N.C. GEN. STAT. § 18B-121 (1983); N.D. CENT. CODE § 5-01-6-1 (Supp. 1983); OHIO REV. CODE ANN. § 4399.01 (Baldwin 1982); R.I. GEN. LAWS §§ 3-14-1 to -15 (1987); UTAH CODE ANN. § 32A-14-1 (1986).

[20] For a complete discussion of liability of both commercial and non-commercial suppliers based on statutory violations, see Annotation, *Common Law Right of Action for Damage Sustained by Plaintiff in Consequence of Sale or Gift of Intoxicating Liquor or Habit-Forming Drug to Another*, 97 A.L.R. 3d 528 (1980).

third persons injured by intoxicated persons served in violation of the statute.[21] The courts find that the applicable alcoholic beverage control act was enacted to protect the general public[22] or persons who could foreseeably be injured by the intoxication of the individual served.[23]

All fifty states and the District of Columbia have alcoholic beverage control acts.[24] Some of these states continue to follow the old common-law rule and refuse to allow civil liability for serving alcohol in the absence of a dram shop act.[25] However, most states now hold that violation by a vendor of an alcoholic beverage control act constitutes either negligence per se or evidence of negligence.[26] The majority recognize the violation as negligence per se, while the minority believe it to

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[21] Comment, *Liability of Commercial Vendors, Employers, and Social Hosts for Torts of the Intoxicated*, 19 WAKE FOREST L. REV. 1013, 1018 (1983).

[22] *See, e.g.*, McClellan v. Tottenhoff, 666 P.2d 408, 413 (Wyo. 1983) (statutory duty toward general public).

[23] *See, e.g.*, Lopez v. Maez, 98 N.M. 625, 651 P.2d 1269, 1276 (1982) (liability for foreseeable consequences of violation of statute prohibiting sale of alcoholic beverage to intoxicated person).

[24] For a list of statutes, see Comment, *Third Party Liability for Drunk Driving: When "One for the Road" Becomes One for the Courts*, 29 VILL. L. REV. 1119, 1137 n.84 (1983-84).

[25] *See supra* note 14.

[26] The following 25 jurisdictions allow a cause of action against a vendor based on violation of an alcoholic beverage control act: Alaska, Morris v. Farley Enters., Inc., 661 P.2d 167, 169 (Alaska 1983); Arizona, Brannagan v. Raybuck, 136 Ariz. 513, 667 P.2d 213, 216 (1983); District of Columbia, Marusa v. District of Columbia, 484 F.2d 828, 833 (D.C. Cir. 1973); Florida, Barber v. Jensen, 450 So. 2d 830, 831 (Fla. 1984), *limited by* FLA. STAT. ANN. § 768.125 (West Supp. 1984); Hawaii, Ono v. Applegate, 62 Haw. 513, 612 P.2d 533, 537 (1980); Indiana, Ashlock v. Norris, 475 N.E.2d 1167, 1169 (Ind. Ct. App. 1985); Iowa, Haafke v. Mitchell, 347 N.W.2d 381, 385 (Iowa 1984); Kentucky, Pike v. George, 434 S.W.2d 626, 629 (Ky. 1968); Louisiana, Thrasher v. Leggett, 373 So. 2d 494, 497 (La. 1979); Massachusetts, Michnik-Zilberman v. Gordon's Liquor, Inc., 390 Mass. 6, 453 N.E.2d 430, 434 (1983); Michigan, Thaut v. Finely, 50 Mich. App. 611, 213 N.W.2d 820, 822 (1973); Minnesota, Trail v. Christian, 298 Minn. 101, 213 N.W.2d 618, 624 (1973); Mississippi, Munford, Inc. v. Peterson, 368 So. 2d 213, 217 (Miss. 1979); Missouri, Carver v. Schafer, 647 S.W.2d 570, 575 (Mo. Ct. App. 1983); New Hampshire, Ramsey v. Anctil, 106 N.H. 375, 211 A.2d 900, 901 (1965); New Jersey, Rappaport v. Nichols, 31 N.J. 188, 156 A.2d 1, 9 (1959); New Mexico, Lopez v. Maez, 98 N.M. 625, 651 P.2d 1269, 1276 (1982); New York, Berkeley v. Park, 47 Misc. 2d 381, 262 N.Y.S.2d 290 (Sup. Ct. 1965); North Carolina, Hutchens v. Hankins, 63 N.C. App. 1, 303 S.E.2d 584, 593 (1983); Oregon, Chartrand v. Coos Bay Tavern, 298 Or. 689, 696 P.2d 513, 517 (1984); Pennsylvania, Couts v. Ghion, 281 Pa. 135, 421 A.2d 1184, 1187 (1980); South Dakota, Waltz v. City of Hudson, 327 N.W.2d 120, 122 (S.D. 1982); Tennessee, Brookins v. Roundtable, Inc., 624 S.W.2d 547, 550 (Tenn. 1981); Wisconsin, Sorensen v. Jarvis, 119 Wis. 2d 627, 350 N.W.2d 108, 113 (1984); Wyoming, McClellan v. Tottenhoff, 666 P.2d 408, 414 (Wyo. 1983).

be simply evidence of negligence.[27] After a duty to the plaintiff is established, it is a jury question as to whether the violation of the statute was the proximate cause of the plaintiff's injuries.[28]

II. Mississippi's Alcoholic Beverage Control Acts

A. Relevant Liability Statutes

The Mississippi Supreme Court has recognized a private right of action[29] against an alcohol vendor for injuries caused by violations of Mississippi's alcoholic beverage control acts, which are found in title 67, Alcoholic Beverages.[30] The two chapters that courts have looked to are chapter 1, Local Option Alcoholic Beverage Control,[31] and chapter 3, Sale of Light Wine, Beer, and Other Alcoholic Beverages.[32] Chapter 1 allows the state's counties to have option elections to determine whether liquor or wine may be sold in those counties and also provides for regulation of its manufacture and sale.[33] Chapter 3 contains parallel provisions governing the manufacture and sale of beer and light wine.[34]

Two statutes from chapter 1 are relevant to liability of commercial alcohol vendors.[35] The first concerns sales of liquor to minors and the penalties involved and states:

> Any permittee or other person who shall sell, furnish, dispose of, give, or cause to be sold, furnished, disposed of, or given, any alcoholic beverage to any person under the age of twenty-one (21) years shall be guilty of a misdemeanor and shall be punished . . . .[36]

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[27] Comment, *supra* note 24, at 1140.

[28] *Id.* at 1140-41.

[29] *See* Munford, Inc. v. Peterson, 368 So. 2d 213, 216-17 (Miss. 1979) (allowing for recovery when violation of alcoholic beverage statute causes injury).

[30] Miss. Code Ann. §§ 67-1-1 to -3-71 (1972 & Supp. 1989). The Mississippi statutes have sometimes been erroneously referred to as "Dram Shop" laws. Cuevas v. Royal d'Iberville Hotel, 498 So. 2d 346, 348 (Miss. 1986). This designation is erroneous because the state's alcoholic beverage control statutes do not expressly provide for a civil cause of action against violators. *Id.* The Mississippi Legislature passed a dram shop act in 1986, but the act never took effect because it was vetoed by the governor. *Id.* & n.1.

[31] Miss. Code Ann. §§ 67-1-1 to -91.

[32] *Id.* §§ 67-3-1 to -71.

[33] *See id.* § 67-1-7 (general applicability of chapter).

[34] *See id.* § 67-3-1 (declaration of purpose).

[35] *Id.* §§ 67-1-81, -83.

[36] *Id.* § 67-1-81. Under the provisions of the statute, an offender is subject to fines, or imprisonment, or both. *Id.* For a second offense, the vendor's permit is automatically revoked. *Id.* The statute further provides that any person under 21 years of age who

The second statute relates to other prohibited sales and the penalty involved and states:

> (1) It shall be unlawful for any permittee or other person to sell or furnish any alcoholic beverage to any person who is known to be insane or mentally defective, or to any person who is visibly intoxicated, or to any person who is known to habitually drink alcoholic beverages to excess, or to any person who is known to be an habitual user of narcotics or other habit-forming drugs. . . .
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> . . . .
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> (4) Any person who shall violate any of the provisions of this section shall be guilty of a misdemeanor, and upon conviction, shall be punished . . . .[37]

Two statutes from chapter 3 are also relevant concerning liability of commercial alcohol vendors.[38] The first places the following restriction upon the sale of beer and light wine:

> In addition to any act declared to be unlawful by this chapter, or by Sections 27-71-301 through 27-71-347, and Sections 67-3-17, 67-3-27, 67-3-29 and 67-3-57, it shall be unlawful for the holder of a permit authorizing the sale of beer or wine at retail:
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> . . . .
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> (b) To sell, give, or furnish any beer or wine to any person visibly or noticeably intoxicated, or to any insane person, or to any habitual drunkard, or to any

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purchases or possesses alcohol in a public place is likewise guilty of a misdemeanor. *Id.* Heavier penalties are to be imposed, under the statute, on a minor who lies about his age for the purpose of purchasing alcohol illegally. *Id.*

[37] *Id.* § 67-1-83. The statute imposes penalties of fines, imprisonment, or both, in addition to revocation of an offender's permit. *Id.* The statute further provides:

> It shall be unlawful for any permittee or other person to sell or furnish any alcoholic beverage to any person to whom the commission has, after investigation, decided to prohibit the sale of such beverages because of an appeal to the commission so to do by the husband, wife, father, mother, brother, sister, child or employer of such person. The interdiction in such cases shall last until removed by the commission, but no person shall be held to have violated this subsection unless he has been informed by the commission, by registered letter, that it is forbidden to sell to such individual or unless such fact is otherwise known to such permittee or other person.

Id.

An additional provision restricts the sale of alcoholic beverages to any persons between certain hours, as well as on certain holidays. *Id.*

[38] *Id.* §§ 67-3-53, -69.

person under the age of twenty-one (21) years.[39]

The second statute relates to the penalties involved for the violation of the above statute.[40]

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[39] *Id.* § 67-3-53. The remainder states that it is also unlawful:

(a) To sell or give to be consumed in or upon any licensed premises any beer or wine between the hours of midnight and seven o'clock the following morning or during any time the licensed premises may be required to be closed by municipal ordinance or order of the board of supervisors; provided, however, in areas where the sale of alcoholic beverages is legal under the provisions of the local alcoholic beverage control law and the hours for selling such alcoholic beverages have been extended beyond midnight for on-premises permittees under Section 67-1-37, the hours for selling beer or light wines are likewise extended in areas where the sale of beer and light wines is legal in accordance with the provisions of this chapter.

. . . .

(c) To permit in his premises any lewd, immoral or improper entertainment, conduct or practices.

(d) To permit loud, boisterous or disorderly conduct of any kind upon his premises or to permit the use of loud musical instruments if either or any of the same may disturb the peace and quietude of the community wherein such business is located.

(e) To permit persons of ill repute, known criminals, prostitutes or minors to frequent his licensed premises, except minors accompanied by parents or guardians, or under proper supervision.

(f) To permit or suffer gambling or the operation of games of chance upon his licensed premises.

(g) To receive, possess or sell on his licensed premises any beverage of any kind or character containing more than four percent (4%) of alcohol by weight unless the licensee also possesses an on-premises permit under the local option alcoholic beverage control law.

Id.

[40] *Id.* § 67-3-69. This statute provides:

(1) Except as to Sections 67-3-17, 67-3-23, 67-3-27, 67-3-55 and 67-3-57, any violation of any provision of this chapter or any rule or regulation of the commissioner, shall be a misdemeanor and, where the punishment thereof is not elsewhere described herein, shall be punished by a fine of not more than Five Hundred Dollars ($500.00) or imprisonment for not more than six (6) months, or both, in the discretion of the court. If any person so convicted shall be the holder of any permit or license issued by the commissioner under authority of this chapter, such permit or license shall from and after the date of such conviction be void and the holder thereof shall not thereafter, for a period of one (1) year from the date of such conviction, be entitled to any permit or license for any purpose authorized by this chapter. Upon conviction of the holder of any permit or license, the appropriate law enforcement officer shall seize the permit or license and transmit it to the commissioner.

. . . .

(3) If the holder of a permit, or the employee of the holder of a permit, shall be convicted of selling any beer or wine to any person under the age of twenty-one

In essence, these statutes make it a misdemeanor and provide for fines, imprisonment, and/or the prohibition of sale if beer, wine, or liquor is unlawfully sold to persons who are insane, obviously intoxicated, alcoholics, drug addicts, or under the age of twenty-one.

B. Immunity from Liability Statute

The Mississippi Legislature has recently added a statute to the alcoholic beverage control acts that provides immunity to certain persons for selling or furnishing alcohol to one causing damage.[41] The parts relevant to commercial alcohol vendors state:

> (1) The Mississippi Legislature finds and declares that the consumption of intoxicating beverages, rather than the sale or serving or furnishing of such beverages, is the proximate cause of any injury, including death and property damage, inflicted by an intoxicated person upon himself or upon another person. (2) Notwithstanding any other law to the contrary, no holder of an alcoholic beverage, beer or light wine permit, or any agent or employee of such holder, who lawfully sells or serves intoxicating beverages to such person who may lawfully purchase such intoxicating beverages, shall be liable to such person or to any other person or to the estate, or survivors of either, for any injury suffered off the licensed premises, including wrongful

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(21) years from the licensed premises in violation of section 67-3-53(b), then, in addition to any other penalty provided for by law, the holder of the permit may be punished as follows:

(a) For the first offense on the licensed premises, the holder of the permit may be fined in an amount not to exceed Five Hundred Dollars ($500.00) and/or the sale of beer or wine on the premises from which the sale occurred may be prohibited for three (3) months.

(b) For a second offense occurring on the licensed premises within twelve (12) months of the first offense, the holder of the permit may be fined in an amount not to exceed One Thousand Dollars ($1,000.00) and/or the sale of beer or wine on the premises from which the sale occurred may be prohibited for six (6) months.

(c) For a third or subsequent offense occurring on the licensed premises within twelve (12) months of the first, the holder of the permit may be fined in an amount not to exceed Five Thousand Dollars ($5,000.00) and/or the sale of beer or wine on the premises from which the sale occurred may be prohibited for one (1) year.

Id. The statute further absolves from responsibility a vendor who sells alcohol to a person under the age of 21 if that person has convincingly represented himself as an adult of 21 years or older. *Id.*

[41] *Id.* § 67-3-73.

death and property damage, because of the intoxication of the person to whom the intoxicating beverage was sold or served.

. . . .

(4) The limitation of liability provided by this section shall not apply to any person who causes or contributes to the consumption of alcoholic beverages by force or by falsely representing that a beverage contains no alcohol, or to any holder of an alcoholic beverage, beer, or light wine permit, or any agent or employee of such holder when it is shown that the person making a purchase of an alcoholic beverage was at the time of such purchase visibly intoxicated.[42]

This recent immunity statute raises some serious questions concerning liability of commercial alcohol vendors which will be discussed below.[43]

III. Court Interpretations

A. *Munford, Inc. v. Peterson*

The seminal case involving commercial alcohol vendor liability in Mississippi is *Munford, Inc. v. Peterson*.[44] In *Munford*, a convenience store clerk sold beer to several minors in one night on several different occasions.[45] One of the boys later drove an automobile, and a wreck

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[42] *Id.* The remainder deals with social host immunity and states:

(3) Notwithstanding any other law to the contrary, no social host who serves or furnishes any intoxicating beverage to a person who may lawfully consume such intoxicating beverage shall be liable to any person or to any other person or to the estate, or survivors of either, for any injury suffered off such social host's premises, including wrongful death and property damage, because of the intoxication of the person to whom the intoxicating beverages were served or furnished. No social host who owns, leases, or otherwise lawfully occupies a premises on which, in his absence and without his consent, intoxicating beverages are consumed by a person who may lawfully consume such intoxicating beverage shall be liable to such person or to any other person or to the estate, or survivors of either, for any injury suffered off the premises, including wrongful death and property damage, because of the intoxication of the person who consumed the intoxicating beverages.

Id.

[43] *See infra* text accompanying notes 122-30.

[44] 368 So. 2d 213 (Miss. 1979).

[45] *Munford*, 368 So. 2d at 215. One of the boys was 15, three were 14, and one was 13. *Id.* at 214. On three occasions that night, the boys purchased a six-pack of beer, with a different boy buying each time. *Id.* at 215. In only the first instance was any inquiry made concerning age, and in that instance an answer was given in the affirmative, and no proof was required. *Id.*

followed,[46] killing one of the minor passengers.[47] After a brief discussion of the common-law rule of no liability,[48] the court stated that the alcoholic beverage control statute involving the sale of beer to a minor was enacted not only for the legalization and regulation of the manufacture and sale of such beverages, but also for the protection of the general public, including the deceased.[49] The court also declared that when a statute is violated, the injured party is entitled to an instruction that the party violating the statute is guilty of negligence as a matter of law,[50] and that if such negligence was a proximate cause of the injury, recovery is allowed.[51] The court concluded that it was a jury question as to whether a causal connection existed between a driver's incompetence as a result of drinking and the accident.[52] The intoxication only had to be a contributing cause to the accident, not the sole proximate cause.[53]

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[46] *Id.* at 215. Tommy Blankenship, also a defendant, was driving west on U.S. Highway 90 about 4:00 a.m. *Id.* With water on the road from a hard rain, he lost control, crossed the median and south lanes of the highway and hit the seawall. *Id.* The car traveled 57 feet in the air, landed on the beach, and turned over five times, traveling 337 ½ feet. *Id.*

[47] *Id.* Scott Peterson was thrown out of the car, and it rolled over him, fatally crushing his chest. *Id.*

[48] *Id.*

[49] *Id.* at 216. The complaint charged Munford, Inc., with selling beer to the minors in violation of Mississippi law and alleged that such negligence contributed to the wreck and the death of Peterson. *Id.* Blankenship was also charged with negligence in the operation of the automobile. *Id.* at 215. The jury returned a verdict for $100,000 against Munford, Inc., and in favor of Blankenship. *Id.* at 214.

The court, quoting extensively from Alexander v. Graves, 178 Miss. 583, 173 So. 417 (1937), noted that the Mississippi Supreme Court had previously recognized the legislative intent in the beer and wine statutes which reflected a concern for public safety. *Munford*, 368 So. 2d at 216-17.

[50] *Munford*, 368 So. 2d at 217. The court stated that this proposition was so elementary that no citation of authority was required. *Id.*

[51] *Id.*; *see supra* note 29 and accompanying text. The court noted that the appellant's demurrer claiming failure to state a claim upon which relief could be granted admitted that the law was violated. *Id.* Therefore the court found that the trial court properly overruled appellant's demurrer and was also correct in giving a peremptory instruction on negligence. *Id.*

[52] *Id.* Appellant also contended that its motions for directed verdict and JNOV were erroneously overruled. *Id.* at 218. However, the court ruled that the evidence was sufficient to withstand these motions. *Id.*

[53] *Id.* at 217. The case was reversed and remanded by the court because the trial judge incorrectly instructed the jury that, as a matter of law, it could not find that plaintiff was contributorily negligent. *Id.* at 218, 220. In reaching its decision, the court found the evidence undisputed that the deceased and other boys pooled their money to buy beer, that they were all drinking, and that Peterson knew Blankenship had been drink-

B. *Cuevas v. Royal D'Iberville Hotel*

In *Cuevas v. Royal D'Iberville Hotel*,[54] the Mississippi Supreme Court addressed the question of the coverage of protection provided by the alcoholic beverage control acts.[55] The female plaintiff, who was staying at a hotel,[56] fell over a railing thirty feet to the lobby floor.[57] She contended that, although she had been visibly intoxicated, she was still served alcohol; that her intoxication caused or contributed to her fall and injuries; and that the defendant was negligent in violating the statute prohibiting serving alcohol to a visibly intoxicated person.[58]

In a four-to-four vote, the court upheld the circuit judge's dismissal.[59] The court stated that, although many criminal statutes have been adopted by the courts as allowing for civil actions in negligence, the legislative policy is to protect only a limited class of individuals.[60] The court reasoned that the plaintiff must be within that class to maintain an action based on the statute.[61] Otherwise the violation would not even constitute evidence of negligence.[62] The court then held that the public—that is, a third-party class, whether minor or adult—was protected under the statute from the negligent acts of an intoxicated person, and that members of the public had a claim against persons or businesses which violated the statute by furnishing alcoholic beverages to minors.[63] The court found no legislative intent, however, to impose

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ing. *Id.* at 219. Accordingly, the court found that the above instruction contradicted the evidence and as a result kept the jury from applying comparative negligence to limit plaintiff's recovery. *Id.* Hence the instruction was found to be unduly prejudicial, constituting reversible error. *Id.*

[54] 498 So. 2d 346 (Miss. 1986).

[55] *Cuevas*, 498 So. 2d at 347-48. The Circuit Court of Harrison County dismissed the suit on motion for summary judgment. *Id.* at 346.

[56] *Id.* at 347. The appellant was injured November 12, 1981, while attending a medical technician's convention. *Id.*

[57] *Id.* The railing was approximately eight inches lower than the minimum height required by building codes. *Id.* A settlement was reached with respect to a claim based on the low rail. *Id.* at 349 (Dan Lee, J., dissenting).

[58] *Id.* at 347. Appellant's claim was based on an alleged violation of § 67-1-83(1). *Cuevas*, 498 So. 2d at 347; *see supra* note 37 and accompanying text.

[59] *Cuevas*, 498 So. 2d at 349.

[60] *Id.* at 347. The court noted that there are criminal statutes that are considered to create no duty of conduct toward the plaintiff and to afford no basis for the creation of such a duty by the court. *Id.* (citing W. PROSSER, THE LAW OF TORTS § 36 (4th ed. 1971)).

[61] *Id.* The court also stated that if the supposed legislative policy is to be accomplished, the harm suffered must be the kind the statute was intended to prevent. *Id.*

[62] *Id.* at 348.

[63] *Id.* The court quickly explained that it had addressed previously similar questions involving these statutes and third-party claimants. *Id.* The court referred to Munford,

liability when an adult individual has voluntarily consumed alcohol, and then as a result of her inebriated condition has injured herself.[64] The court therefore found the plaintiff to be outside the protected class.[65]

In a scathing dissent,[66] Justice Robertson questioned the validity of such an interpretation of legislative intent.[67] He noted that the statute was silent on the question of whether a private right of action was available.[68] However, because of the accidents attributable to alcohol consumption and the need to respond to the social costs, he maintained that private enforcement through the tort system should be available under the alcoholic beverage control statute in question.[69] Concerning the court's holding that the plaintiff was not in the protected class, Justice Robertson noted that no statutory language mentioned the class of persons protected and that no published legislative history was available.[70] He considered the most appropriate interpreta-

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Inc. v. Peterson, 368 So. 2d 213 (Miss. 1979). *Cuevas*, 498 So. 2d at 348; *see supra* notes 44-53 and accompanying text. The *Cuevas* court also cited Boutwell v. Sullivan, 469 So. 2d 526 (Miss. 1985), a case which involved a third-party complaint against a social host for the death of the plaintiff's decedent. The complaint alleged that the death was caused by the drunken condition of an automobile operator, whose host had supplied him with alcohol. *Cuevas* 498 So. 2d at 348 (citing *Boutwell*, 469 So. 2d at 528). The host in the *Boutwell* case was not liable because he was not covered by the statute, and, under common law, no liability was imposed. *Id.*

[64] *Cuevas*, 498 So. 2d at 348. The court noted that in criminal law intoxication was no defense. *Id.* at 348 n.2.

[65] *Id.* at 349. The court noted that jurisdictions were divided on this question. *Id.* at 349. n.3.

[66] *Id.* at 354-62. Justice Dan Lee also dissented, although not as vigorously as Justice Robertson. *Id.* at 349-54. Basically, Justice Lee examined the doctrine of negligence per se for violation of a criminal statute, analyzed § 67-1-83(1), and surveyed other jurisdictions. *Cuevas*, 498 So. 2d at 349-54. Justice Lee then explained holdings from Pennsylvania, Massachusetts, South Dakota, and South Carolina that allowed the intoxicated consumer to recover. *Id.* at 352-54. Justice Lee concluded that he was not absolving intoxicated consumers, as here the plaintiff would still have to show a statutory violation, injuries, and proximate cause. *Id.* at 354. The plaintiff also would be subject to affirmative defenses, such as assumption of risk and contributory negligence. *Id.*

[67] *Cuevas*, 498 So. 2d at 357-59.

[68] *Id.* at 357. Justice Robertson stated that the majority's reliance on legislative intent was a futile and ill-advised exercise, especially since no legislative history was available to make the intent of the statute clear. *Id.*

[69] *Id.* at 358. He felt that statutes should be interpreted, not by speculations as to legislative intent, but by determining the best construction through an enlightened search for the most appropriate interpretation. *Id.* Justice Robertson noted that this case was similar to *Munford*, where a private right of action was allowed, and that an opposite holding here would be inconsistent. *Id.* at 358.

[70] *Id.* at 359. Once again criticizing the emphasis on legislative intent, he pointed

tion to be one which would allow a private right of action to anyone injured as a proximate result of an alcohol vendor's violation of statute, subject only to defenses provided by law.[71] However, he would have barred Cuevas' action on the defense of assumption of risk.[72]

C. *Bryant v. Alpha Entertainment Corp.*

In *Bryant v. Alpha Entertainment Corp.*,[73] two minors were admitted into a bar where they bought beer.[74] When they were driving home later, the driver hit a bridge abutment, killing the passenger.[75] The subsequent lawsuit was based on a violation of the statute prohibiting the sale of beer to a minor.[76] The defendant argued that the plaintiffs had the burden of proving a lack of reasonable care by the defendant's employees in determining the age of the minors.[77] Rejecting this argument and relying on *Munford*, the court stated that the method of determining a minor's age was for the owner to select[78]

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out that the language to be interpreted comprised only a small part of a lengthy, complex statute, that the average legislator voting on the bill was probably unaware of the language, and that those who were aware of it probably understood it in various different ways. *Id.*

[71] *Id.* at 360.

[72] *Id.* at 360-62. Justice Robertson felt that Cuevas voluntarily and knowingly incurred the risk of danger to herself and that she should be charged with the knowledge that injury was likely to result. *Id.* at 360. Justice Robertson also pointed out that some might believe the deterrent policy would be served just as well by excluding intoxicated direct consumers from the class of persons who might sue upon the statute. *Id.* at 361. He preferred his own construction, however, maintaining that not every intoxicated consumer-plaintiff should be barred by assumption of risk. *Id.* As an example, some young or inexperienced drinkers may not assume the risk. *Id.* Finally, in a footnote, he severely criticized defense counsel's failure to plead assumption of risk. *Id.* at 362 n.14.

[73] 508 So. 2d 1094 (Miss. 1987).

[74] *Bryant*, 508 So. 2d at 1095. Dinah Kay Bryant and Kevin King, both under 18, gained admittance into Cash McCool's, a bar owned by Alpha, in Hattiesburg, by using fake I.D.'s. *Id.* King testified that he bought and drank four to six beers. *Id.*

[75] *Id.* Injuries caused by this accident led to Bryant's death. *Id.*

[76] *Id.* at 1096. This statute was § 67-3-53. *Bryant*, 508 So. 2d at 1096; *see supra* note 39 and accompanying text. Judgment was entered in Lamar County Circuit Court on a jury verdict in favor of Alpha, and the Bryants appealed. *Bryant*, 508 So. 2d at 1094.

[77] *Bryant*, 508 So. 2d at 1096-97. The trial court granted Alpha's request for a jury instruction which basically required the Bryants to prove by a preponderance of the evidence that Alpha had failed to exercise reasonable care in order for Alpha to be found negligent. *Id.* at 1096. Three negligence per se instructions requested by the Bryants were refused. *Id.* The judge did allow two additional instructions by the Bryants, but he placed the burden on the Bryants to prove negligence and causal connection. *Id.*

[78] *Id.* at 1097.

and that it was his responsibility not to violate the law.[79] Since the law was violated, the defendant's conduct amounted to negligence per se.[80] Turning to the issue of punitive damages,[81] the court found that punitive damages might be allowed only on proof of gross negligence or willful misconduct.[82] The court concluded that the conduct of the defendant did not show evidence of reckless and wanton disregard for the safety of others.[83] Therefore, no punitive damages were allowed.[84]

D. Williams v. United States Fidelity & Guaranty Co.

In a case which came before the Court of Appeals for the Fifth Circuit, *Williams v. United States Fidelity & Guaranty Co.*,[85] three employees of a bar had been drinking while on the job.[86] After work they left in a car, and, after several stops,[87] the driver of the car struck a tree, causing serious injuries to one of his fellow employee passengers.[88] Following a default judgment against the bar and the driver,[89] the plaintiff tried to garnish the bar's insurer.[90] The plaintiff first contended that the tavern violated the law by furnishing alcohol to an

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[79] *Id.* Alpha contended that *Munford* was distinguishable because the minors there were obviously young and the owner did not even request an identification. *Id.* The court found this argument to be without merit and stated that the age requirement in the statute must be applied literally. *Id.*

[80] *Id.* The court reiterated the *Munford* and *Cuevas* holdings that a violation constitutes negligence per se. *Id.*

[81] *Id.* at 1089-99. The trial court had refused punitive damage instructions requested by the Bryants. *Id.* at 1099.

[82] *Id.* at 1099.

[83] *Id.*

[84] *Id.* Accordingly, the court affirmed the refusal to grant punitive damage instructions, and reversed the refusal to grant a negligence per se instruction. *Id.*

[85] 854 F.2d 106 (5th Cir. 1988).

[86] *Williams*, 854 F.2d at 107. The record showed that on the night of June 20, 1982, James Holley, the driver, drank at least eight cups of draft beer while at work on a clean-up crew for The Lamar, Inc., a bar in Jackson. *Id.*

[87] *Id.* They stopped to fix the muffler, to purchase a six-pack of beer at a Stop-N-Go convenience store, to eat breakfast at a local restaurant, and to use a restroom in Clinton. *Id.*

[88] *Id.* James Williams was injured. *Id.*

[89] *Id.* Williams brought suit in state court against Holley, The Lamar, and the Stop-N-Go store for negligent conduct. *Id.* When The Lamar failed to answer the pleadings, the court entered a $2.4 million default judgment against Holley and The Lamar. *Id.* There is no further mention of Stop-N-Go.

[90] *Id.* at 107. Plaintiff filed a suggestion for a writ of garnishment against The Lamar's insurer, United States Fidelity and Guaranty Company. *Id.* USF & G removed that action to federal court, where the district judge, after a bench trial, dismissed the case involuntarily. *Id.* (citing FED. R. CIV. P. 41(b)).

obviously intoxicated person.[91] Although admitting that the complaint stated a cause of action, the Fifth Circuit determined that the insurer did not insure the bar against injuries resulting from its violation of this statute.[92] Thus no recovery could be had against the insurer.[93] The plaintiff further claimed that the bar negligently allowed an intoxicated employee to drive home.[94] However, the court noted that no statute prohibited such conduct and that an employer had no duty to prevent the intoxication of its employees, just as a social host had no duty to prevent intoxication of guests.[95] Finally, the plaintiff asserted a claim that the bar failed to supervise its premises and to prevent its employees from drinking its beer.[96] Again the court found that neither the Mississippi Legislature nor its courts had imposed on employers this kind of duty.[97] Since no cause of action for the second and third claims existed, no consideration of whether the insurance policy would cover them was necessary.[98]

In sum, these four cases illustrate (1) that alcohol vendor liability is available under the alcoholic beverage control acts; (2) that violation of these acts is negligence per se; (3) that proximate cause is a jury question; (4) that an intoxicated adult consumer is not covered by the statutes; (5) that no punitive damages are available unless there is evi-

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[91] *Id.* Since jurisdiction was based on diversity of citizenship, Mississippi law controlled. *Id.* at 107 & n.2 (citing MISS. CODE ANN. § 67-3-53(b) (1972)).

[92] *Williams*, 854 F.2d at 108. The court pointed out that the language of the policy specifically excepted such coverage and that this was a typical provision in insurance policies covering establishments that distributed alcoholic beverages. *Id.* The court also found that the provision was free of ambiguity and that it had been uniformly applied by several other states. *Id.*

[93] *Id.*

[94] *Id.*

[95] *Id.* The court of appeals stated that it could not institute a rule which the Supreme Court of Mississippi had refused to establish. *Id.*

[96] *Id.* at 109.

[97] *Id.* The court recognized that employers have been held liable for the negligent maintenance of work premises in Mississippi. *Id.* However, the court found that the two cases cited by plaintiff in support of the foregoing theory established merely that employers have a duty of "reasonable care" to provide a safe work place for employees; thus the scope of an employer's duty is limited to injuries occurring on the work premises. *Id.* The court noted that plaintiff in the case was not injured at his work place, the tavern, and that Holley was not acting in the course of his employment when plaintiff was injured. *Id.* The court reasoned that the accident and plaintiff's resulting injuries were too far removed from the employer's premises and the scope of plaintiff's or Holley's employment to be attributable to the employer's negligent maintenance of the work premises. *Id.*

[98] *Id.* The court concluded by stating that the default judgment against Williams and The Lamar did not establish the liability of the insurer. *Id.*

dence of gross negligence or willful misconduct; (6) that an insurance policy may exclude coverage to a bar for an alcoholic beverage control act violation; and (7) that no cause of action exists (a) to hold an employer liable for negligently allowing an intoxicated employee to drive, or (b) to hold an employer liable for failing to supervise the premises and prevent employees from drinking its beer.[99]

IV. Problems

A. Class of Persons Covered

The *Cuevas* case illustrates one of the problems in interpreting and applying Mississippi law in this area. In *Cuevas*, the Mississippi Supreme Court confronted the question of who could bring an action against alcohol vendors under the alcoholic beverage control acts.[100] The court found that an adult who voluntarily consumed alcohol and who, because of his intoxicated condition injured himself, could not bring an action.[101]

However, even though the court relied on *Munford* to support its holding,[102] it seems hard to reconcile the two conflicting results. In *Munford*, the court found that the statute which prohibited the sale of beer or light wine to a minor was adopted for the protection of the general public, which included the decedent minor passenger.[103] In *Cuevas*, though, while interpreting a similar statute prohibiting the sale of alcoholic beverages to a visibly intoxicated person,[104] the court held that the public was protected. The court, however, qualified "public" to mean a third-party class, whether minor or adult.[105]

First, even though the decedent in *Munford* was not driving the car at the time of the accident, he was involved in drinking beer which had been purchased by the group.[106] In fact, the case was remanded because the vendor had set up a defense that the decedent was con-

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[99] For a detailed discussion of an insurance exclusion provision arising from a situation very similar to that in *Williams*, see Wilson v. United States Fidelity & Guar. Ins. Co., 830 F.2d 588 (5th Cir.), *aff'g* 659 F. Supp. 553 (S.D. Miss. 1987).

[100] *See supra* notes 54-72 and accompanying text.

[101] *See supra* notes 64-65 and accompanying text.

[102] *See supra* note 63 and accompanying text.

[103] *See supra* note 49 and accompanying text.

[104] For a comparison of MISS. CODE ANN. §§ 67-3-53(b) and -1-83(1) (Supp. 1988), see *supra* text accompanying notes 37 and 39.

[105] *See supra* text accompanying note 63.

[106] Munford, Inc. v. Peterson, 368 So. 2d 213, 219 (1979). The undisputed evidence showed that the decedent and the other boys pooled their money to buy beer. *Id.*

tributorily negligent.[107] Therefore, the decedent in *Munford* was not an "innocent" third party, and could in fact be viewed as an intoxicated consumer. If he was protected under the statute, why should not a visibly intoxicated person served alcohol be protected under an analogous statute? Both should be considered members of the public.

Second, these criminal statutes have been judicially construed to provide civil actions against alcohol vendors.[108] As penal statutes, however, they contain no wording which mentions any class of persons protected.[109] It seems that the better view, as pointed out in the *Cuevas* dissents, would be to construe these statutes as providing a cause of action for anyone injured as a result of an alcohol vendor's statutory violation.[110]

Finally, even if one could sue if injured as a result of an alcohol vendor's statutory violation, he could still be barred from recovery, or recovery could be reduced.[111] The plaintiff would still have to establish proximate cause and damages and to overcome affirmative defenses such as contributory negligence and assumption of risk.[112]

B. Is a Vendor Absolved If He Accepts an Apparently Valid ID?

Another problem arises when a minor gains entrance to a bar or purchases alcohol with an apparently valid ID. According to the *Munford* and *Bryant* decisions, the responsibility of determining the age of the purchaser is that of the owner,[113] and any violation is deemed negligence per se.[114] However, part of the statute relating to penalties for sale of beer to a minor absolves a vendor from that statutory violation if he accepts an apparently valid ID that is consistent with the minor's appearance.[115] If this occurs, does it mean that since there is no violation, then no private right of action exists? Or does it mean that a private right of action exists, but there is no negligence per se and the jury is to determine the issue of negligence?[116] The Mississippi Su-

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[107] *See supra* note 53.

[108] *See supra* notes 48-51 and accompanying text.

[109] *See* MISS. CODE ANN. §§ 67-1-81, -1-83, -3-53, -3-69 (Supp. 1989).

[110] *See supra* notes 66-72 and accompanying text.

[111] *See supra* notes 66, 72 and accompanying text.

[112] For a review of defenses concerning an action by an intoxicated consumer, see S. SPEISER, C. KRAUSE & A. GANS, 3 THE AMERICAN LAW OF TORTS § 9:85, at 237-38 (1986).

[113] *See supra* notes 78-79 and accompanying text.

[114] *See supra* note 80 and accompanying text.

[115] MISS. CODE ANN. § 67-3-69(4) (Supp. 1989); *see supra* note 40.

[116] In a recent Wyoming case allowing a third-party action against a liquor store owner, an issue not addressed was whether one must know or should know that an indi-

preme Court may well face an opportunity to reevaluate its position on this issue in the future.

C. *Who Is To Say Which Drink Caused the Injury?*

Although not discussed in any Mississippi decisions, another issue concerns whether the last alcoholic drink caused a person to injure himself or others. More specifically, if an already intoxicated person is later served alcohol elsewhere, how can it be determined that it was the last serving that caused the accident?[117] In other words, although a jury must usually determine the proximate cause relationship between the alcohol serving and the resulting injury,[118] how can it differentiate between two different alcohol servings at two different places?[119]

There appears to be no easy solution. However, in cases where a person already intoxicated had one additional drink while stopping at the last bar, a court could determine that this last drink could not be the proximate cause of the resulting injuries.[120] And if there is a ques-

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vidual to whom liquor is furnished is a minor in order to violate the alcohol beverage control acts, or whether one who furnishes liquor to a minor violates the statute as a matter of law. McClellan v. Tottenhoff, 666 P.2d 408 (Wyo. 1983). Analogous to MISS. CODE ANN. § 67-3-69(4), the Wyoming statute provided a liquor licensee with an affirmative defense to any criminal prosecution or action for the suspension or revocation of his license when accused of selling liquor to a minor. It permitted the liquor licensee to prove that he demanded, was shown, and acted in reasonable reliance upon, one of the prescribed documents of identification to determine the age and identity of the minor. WYO. STAT. § 12-6-101(e) (1977). In an earlier Wyoming case, however, the court accepted the premise that a liquor licensee was not strictly liable for selling liquor to a minor and was only required to exercise the degree of caution which would be shown by a reasonable prudent person in a similar situation. Rancher Bar & Lounge v. State, 514 P.2d 634, 635 (Wyo. 1973). This reasoning would apparently apply in a civil proceeding. *See generally*, Note, *Torts—Injuries Arising from Negligence in Furnishing Liquor to Minors and Intoxicated Adults: New Tort Action in Wyoming*, 19 LAND & WATER L. REV. 285 (1984) (evolution of theory of vendor liability).

[117] In *Munford*, the record showed that the boys drank a quantity of vodka before buying the three six-packs of beer. Munford, Inc. v. Peterson, 368 So. 2d, 213, 214 (Miss. 1979). Also, in *Williams*, the record showed that after drinking at work, the employees of the tavern purchased more beer at a Stop-N-Go. Williams v. United States Fidelity & Guar. Ins. Co., 854 F.2d 106, 107 (5th Cir. 1988). In fact, the Stop-N-Go was sued, but no indication appears in the record as to the result of this claim. *Id.* Therefore, even though both these Mississippi cases involved two different alcohol servings, no determination was made in either as to which serving caused the intoxication.

[118] *See supra* text accompanying notes 52-53.

[119] No cases were found that discussed this question.

[120] In *Munford*, the converse apparently was true. There, even though the boys drank vodka before buying the three six-packs, since no mention was made of the vodka as a possible cause of the accident, one might infer that the court thought the vodka was

tion of whether reasonable minds could differ, it has been determined that deliberation by a jury is the best way for that decision to be made.[121]

D. *Immunity Statute*

Perhaps the greatest problem concerning the question of alcohol vendor liability is in Mississippi's recently enacted immunity statute.[122] The statute provides that consumption of alcohol, rather than its sale or serving, is the proximate cause of any injury to an intoxicated person or of injury inflicted upon another person by him.[123] A second provision states that an alcohol vendor who lawfully serves alcohol to a lawful purchaser is absolved from any liability.[124] Finally, the statute provides that limitation of liability will not apply to a vendor if the purchaser was visibly intoxicated at the time.[125]

These provisions raise some interesting questions concerning their effect. What is the effect of the third provision? In view of the second provision, the third seems redundant, because if the purchaser is visibly intoxicated, then the vendor is not lawfully selling him alcohol. Also, when sales to minors are involved, no wording in the statute mentions any limitation of liability. However, once again, if sale is made to a minor, should not the vendor be liable under the second provision, since this is an unlawful sale? Or does the third provision furnish the only relief from liability?

The provision that consumption, not sale of alcohol, is the proximate cause of injury is the most serious cause of concern for third parties wishing to bring suits against alcohol vendors. Of course, this was the traditional common-law view.[126] Is the legislature attempting to place Mississippi back into the category of states which adhere to this traditional view? Similar statutes[127] in other states have been con-

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not a proximate cause of the accident. *Munford*, 368 So. 2d at 214.

[121] *See supra* text accompanying note 52.

[122] MISS. CODE ANN. § 67-3-73 (Supp. 1989); *see supra* notes 41, 42 and accompanying text.

[123] Section 67-3-73.

[124] *Id.*

[125] *Id.*

[126] *See supra* notes 12-15 and accompanying text.

[127] *See* MO. ANN. STAT. § 537.053 (Vernon 1988) (consumption is proximate cause of resulting injury, and no action can be brought unless plaintiff can show defendant was convicted of violating statute making it crime to serve minor or visibly intoxicated person); TENN. CODE ANN. § 57-10-102 (Supp. 1988) (consumption is proximate cause of resulting injury, and no action is allowed unless plaintiff can prove beyond reasonable

strued to remove alcohol vendor liability to third persons.[128] If the violation of the statute is negligence per se, with proximate cause being the only issue to decide, then the action would be barred, since the legislature has determined that the sale cannot be the proximate cause.[129] But what about the third provision, which states that immunity does not apply if the sale is made to an obviously intoxicated person? Does that mean the first provision, which attributes causation to consumption rather than sale, would not bar an action if the case involved an obviously intoxicated person? Where does this leave sales to minors?

Obviously, this statute places serious doubt on the imposition of liability on alcohol vendors, especially when similar statutes of other states are examined.[130] As the preceding questions have indicated, the statute is far from clear; and it is only a matter of time before the Mississippi courts must confront these issues.

V. Conclusion

The future development of alcohol vendor liability in Mississippi is uncertain. As explained above, the Mississippi Supreme Court has given third parties injured because of alcohol vendors' illegal servings the right to bring actions based on the applicable alcoholic beverage control act.[131] The only issue is whether the sale proximately caused the injuries.[132] Problems remain, however, in determining whether the alcohol vendor is liable, the major one being the effect of the recent immunity statute.[133] Although the statute appears to limit alcohol vendor liability,[134] the court should do its best to clarify that interpretation. Alternatively, the legislature could assume responsibility and clarify the meaning of the statute. In this way, public pressure could force the legislature to back away from its present stance. Presently, alcohol vendors in Mississippi are exercising greater care to avoid the civil lia-

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doubt that server furnished alcohol to person obviously intoxicated or known by seller to be minor).

[128] *See* Comment, *Server vs. Driver Liability: A Suggested Change to Reduce Drinking and Driving*, 7 N. Ill. U.L. Rev. 257, 268-72 (1987) (statutory curbs on liability).

[129] *See* Miss. Code Ann. § 67-7-73(1) (Supp. 1989) (consumption is proximate cause).

[130] *See supra* notes 127-28 and accompanying text.

[131] *See supra* note 49 and accompanying text.

[132] *See supra* notes 51-53 and accompanying text.

[133] *See supra* notes 122-25 and accompanying text.

[134] *See supra* text accompanying note 129.

bility that was non-existent at common law. The courts, the legislature, and the public should make sure that alcohol vendors continue exercising this degree of care.

Marty Warren

RECENT DECISIONS

Labor Law — Federal Preemption — A State Action Is Preempted Under the Labor Management Relations Act Only if It Is Dependent on the Terms in the Collective Bargaining Agreement

Petitioner[1] filed a retaliatory discharge claim[2] in the Illinois Circuit Court for Williamson County[3] against defendant.[4] The suit alleged that she had been wrongfully dismissed for exercising her rights under Illinois workers' compensation laws.[5] Defendant removed the case to the United States District Court for the Southern District of Illinois.[6] The district court granted defendant's motion to dismiss after finding that the action was preempted[7] by section 301(a) of the Labor Manage-

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[1] Petitioner, Jonna R. Lingle, was an employee of a manufacturing plant in Herrin, Illinois. Lingle v. Norge Div. of Magic Chef, Inc., 108 S. Ct. 1877, 1879 (1988).

[2] *Lingle*, 108 S. Ct. at 1879. The action alleged discharge due to a request for medical compensation for an injury under the Illinois Workers' Compensation Act. *Id.*

[3] *Id.*

[4] *Id.* Defendant, Norge Division of Magic Chef, Inc., operated the manufacturing plant where petitioner was employed. *Id.*

[5] *Id.* Petitioner was terminated by defendant for allegedly filing a false workers' compensation claim for an injury that petitioner maintained occurred during her employment. *Id.* The union representing petitioner filed a grievance under the collective bargaining agreement, which prohibited termination except for "proper" or "just" cause. *Id.* An arbitrator ordered defendant to reinstate petitioner with complete back pay. *Id.*

[6] *Id.* Removal was granted on the basis of diversity of citizenship pursuant to 28 U.S.C. § 1441 (1982). *Lingle*, 108 S. Ct. at 1879.

[7] Lingle v. Norge Div. of Magic Chef, Inc., 618 F. Supp. 1448, 1450 (S.D. Ill. 1985), *aff'd*, 823 F.2d 1031 (7th Cir. 1987), *rev'd*, 108 S. Ct. 1877 (1988). The district court found that the petitioner's claim was "inextricably intertwined" with the collective bargaining section banning discharge without just cause. *Lingle*, 618 F. Supp. at 1449. The district court further stated that the state tort claim would wrongfully supplant remedies for unjust discharge available in the mutually approved collective bargaining agreement.

ment Relations Act (LMRA), which grants federal district courts jurisdiction over suits alleging violations of employer-union contracts.[8] The United States Court of Appeals for the Seventh Circuit affirmed the district court's action.[9] On writ of certiorari,[10] the United States Supreme Court, *held*, reversed.[11] Where application of state law requires no interpretation of a collective bargaining agreement, the state law is not preempted by federal law under section 301(a), even though the analysis under the state law involves the same factual inquiry as would a grievance procedure in the collective bargaining agreement. *Lingle v. Norge Division of Magic Chef, Inc.*, 108 S. Ct. 1877 (1988).

Although government intervention in labor contracts was common in Colonial America, legislative bodies in the United States gradually abandoned regulation of the employer-employee relationship in succeeding centuries.[12] Legislative withdrawal from the field of labor law

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Id. The court also found that the tort claim could result in punitive damages, which were not provided for in the bargaining agreement. *Id.* The district court therefore concluded that the tort claim was preempted by federal law and that the suit should be dismissed. *Id.* at 1449-50.

[8] Labor Management Relations (Taft-Hartley) Act (LMRA) § 301(a), 29 U.S.C. § 185(a) (1982).

> (a) Suits for violation of contracts between an employer and a labor organization representing employees in an industry affecting commerce as defined in this chapter, or between any such labor organizations, may be brought in any district court of the United States having jurisdiction of the parties, without respect to the amount in controversy or without regard to the citizenship of the parties.

Id.

[9] Lingle v. Norge Div. of Magic Chef, Inc., 823 F.2d 1031, 1051 (7th Cir. 1987), *rev'd*, 108 S. Ct. 1877 (1988). The Seventh Circuit merged an appeal of a second, unrelated retaliatory discharge suit with the instant case. *Lingle*, 823 F.2d at 1031. The court of appeals affirmed the dismissal of both suits. *Id.* at 1051. The court of appeals found that not all state law suits relating to a collective bargaining agreement were preempted by § 301(a), but that each must be decided individually. *Id.* at 1046. Nevertheless, the court stated that the claim of retaliatory discharge was "inextricably intertwined" with the grievance procedure contained in the agreement because the tort claim derived from the terms of the agreement. *Id.* The court noted that the possibility of punitive damages, in light of the absence of such damages through the grievance procedures contained in the agreement, did not preclude preemption. *Id.* The court of appeals added that the recognition of state law or common law remedies for unjustifiable discharge would interfere with union recruitment. *Id.* at 1047. Therefore, the court of appeals ruled that the LMRA preempted the retaliatory discharge claim, that the plaintiffs must resort to the grievance procedures contained in the agreement, and that the suit should be dismissed. *Id.* at 1051.

[10] *Lingle*, 108 S. Ct. at 1877.

[11] *Id.* The Court's decision was unanimous. *Id.* at 1878.

[12] Stone, *The Post-War Paradigm in American Labor Law*, 90 YALE L.J. 1511, 1512

received a judicial boost in the early part of this century when the United States Supreme Court struck down labor legislation on both the state[13] and federal[14] levels. These adverse decisions, however, did not deter a Depression-era Congress from adopting the National Labor Relations Act (NLRA), which established comprehensive labor regulations, recognized employees' right to organize and collectively bargain, and created the National Labor Relations Board (NLRB).[15]

Reversing a long trend of judicial intolerance of legislative regulation of labor,[16] the United States Supreme Court upheld the constitutionality of the NLRA in *NLRB v. Jones & Laughlin Steel Corp.*[17] Confronted with an alleged violation of the NLRA's guarantee of workers' right to organize[18] by a corporate employer,[19] the United States Supreme Court found the Act to be a permissible exercise of congressional authority under the commerce clause.[20] The Court stated in dic-

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(1981). By the 19th Century, the wage contract was viewed as strictly a private transaction and beyond the reach of government regulation. *Id.*

[13] *E.g.*, Coppage v. Kansas, 236 U.S. 1, 26 (1914) (declaring unconstitutional state statute making it criminal offense to bar employee from joining union); Lochner v. New York, 198 U.S. 45, 57-65 (1905) (striking down state law regulating bakers' work hours).

[14] *E.g.*, Carter v. Carter Coal Co., 298 U.S. 238, 289-310 (1936) (striking down congressional act controlling wages and working conditions of coal miners); Adair v. United States, 208 U.S. 161, 171-80 (1908) (blocking enforcement of congressional act banning discharge of employees for joining unions). *See generally* Weeks, *NLRA Preemption of State Common Law Discharge Claims: The Bhopal Brigade Goes Home*, 13 PEPPERDINE L. REV. 607, 612-14 (1986) (outlining development of labor law preemption).

[15] National Labor Relations Act (NLRA), 29 U.S.C. §§ 151-69 (1982). The NLRA established the National Labor Relations Board (NLRB). *Id.* § 153. The right of employees to organize and collectively bargain was recognized. *Id.* § 157. Unfair labor practices were defined. *Id.* § 158. The NLRB was empowered to hear allegations of unfair labor practices. *Id.* § 159. Congress incorporated the NLRA into the LMRA, or Taft-Hartley Amendments. LMRA, 29 U.S.C. §§ 141-87 (1982).

[16] Note, *Labor Law Preemption*: Allis-Chalmers Corp. v. Lueck, 60 TUL. L. REV. 1077, 1079 (1986).

[17] 301 U.S. 1, 49 (1937); *cf.* West Coast Hotel Co. v. Parrish, 300 U.S. 379, 400 (1937) (upholding state regulations of minimum wages).

[18] *Jones & Laughlin*, 301 U.S. at 22. A labor union filed a complaint with the NLRB claiming an employer had discriminated against union members in hiring and tenure and had interfered with union organizing. *Id.* The NLRB ruled that the employer had violated the NLRA. *Id.* at 25.

[19] *Id.* at 25-26. The employer, Jones & Laughlin, was incorporated in Pennsylvania and headquartered in Pittsburgh. *Id.* Jones & Laughlin, the nation's fourth largest steel producer, owned 19 subsidiaries that encompassed mines, railroads, warehouses, and other facilities in several states. *Id.* at 26-27.

[20] *Id.* at 30-31. The commerce clause of the United States Constitution states: "The Congress shall have power . . . to regulate commerce with foreign nationals, and among the several states, and with the Indian tribes." U.S. CONST. art. 1, § 8, cl. 3.

tum that the NLRA authorized the NLRB to prevent unfair labor practices[21] only if interstate commerce was affected.[22] Explaining that the NLRA's declaration[23] stated that it was intended to end labor disputes that impeded commerce,[24] the Court ruled that congressional efforts to remove obstructions to interstate or foreign commerce were constitutional.[25] After upholding Congress' decision to safeguard workers' right of self-organization,[26] the Court found that this protection extended to manufacturing employees not directly involved in commerce.[27] This, also, the Court explained, was authorized by the commerce clause.[28]

Twenty years after recognizing the constitutionality of congres-

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[21] *Jones & Laughlin*, 301 U.S. at 30.

[22] *Id.* at 30-31. The Court stated that the NLRA restricted the NLRB's jurisdiction to unfair labor practices affecting commerce. *Id.* at 30. The Court further interpreted the LMRA's definition of commerce to be interstate and thus within the scope of the commerce clause. *Id.* at 31.

[23] 29 U.S.C. § 151 (1982).

[24] *Jones & Laughlin*, 301 U.S. at 23.

[25] *Id.* at 30-31.

[26] *Id.* at 33. The Court found that Congress envisioned collective bargaining as promoting peaceful employer-employee relations. *Id.* at 34. A ban on interference in labor organization, the court reasoned, protects both workers' and employers' constitutional rights. *Id.*

[27] *Id.* at 35. The alleged victims of the unfair labor practices were production workers in Jones & Laughlin's plants. *Id.* at 28.

[28] *Id.* at 35. The Court ruled that production was just one phase in an integrated flow of interstate commerce of steel products manufactured by Jones & Laughlin. *Id.* It was immaterial, the Court stated, that a congressionally regulated activity such as a local manufacturing operation was intrastate in nature, as long as the activity had a "close and substantial relationship" to interstate commerce. *Id.* at 37. The Court found that, in such cases, congressional control was permissible if it was necessary to clear roadblocks to interstate commerce. *Id.*

In companion cases decided the same day as *Jones & Laughlin*, the Supreme Court affirmed the constitutionality of NLRB regulations of other forms of interstate commerce. *See* Washington, Va. & Md. Coach Co. v. NLRB, 301 U.S. 142, 147 (1937) (transportation of passengers between states by bus); NLRB v. Friedman-Harry Marks Clothing Co., 301 U.S. 58, 75 (1937) (manufacture of clothes sold out of state); Associated Press v. NLRB, 301 U.S. 103, 133 (1937) (interstate transmission of news by press service); NLRB v. Fruehauf Trailer Co., 301 U.S. 49, 53 (1937) (manufacture of trailers sold out of state).

Four Justices issued a single dissenting opinion, written by Justice McReynolds, that applied to all three cases—*Jones & Laughlin*, *Fruehauf Trailer* and *Friedman-Harry Marks*. 301 U.S. at 76. The dissenting opinion argued that congressional power through the NLRB should not extend to purely local manufacturing operations with only tangential connections to interstate commerce. *Id.* at 93-99. The commerce clause did not authorize congressional regulation of activities that have only a possibility of affecting interstate commerce, according to the opinion. *Id.* at 99-101.

sional labor regulations through the NLRA,[29] the Supreme Court expanded the breadth of federal labor law in *Textile Workers Union v. Lincoln Mills*.[30] In *Lincoln Mills*, the Supreme Court held that when faced with suits alleging a violation of union contracts under section 301(a),[31] courts should interpret labor contracts through federal substantive law.[32] Rejecting a very literal reading of section 301(a),[33] the *Lincoln Mills* Court adopted the findings of most lower courts[34] in ruling that the section authorized courts to use federal substantive law to enforce arbitration clauses in collective bargaining agreements.[35] After reciting the legislative history of the LMRA,[36] the Court concluded

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[29] *See supra* note 17 and accompanying text.

[30] 353 U.S. 448 (1957).

[31] *See supra* note 8 and accompanying text. In *Lincoln Mills*, a union and employer, Lincoln Mills, entered a contract that banned strikes but provided for a grievance procedure ending in arbitration. *Lincoln Mills*, 353 U.S. at 449. The union requested arbitration after exhausting the preliminary steps in the grievance procedure, but Lincoln Mills refused. *Id.* The union sued to compel arbitration. *Id.*

[32] *Lincoln Mills*, 353 U.S. at 457.

[33] *Id.* at 450. The *Lincoln Mills* Court dismissed the view that § 301(a) only granted federal district courts jurisdiction over disputes involving labor contracts affecting commerce, regardless of diversity of citizenship or amount in controversy. *Id.* The Court noted such an interpretation would furnish neither federal nor state substantive law to courts. *Id.*

[34] *Id.*; *see, e.g.*, United Elec. Workers v. Oliver Corp., 205 F.2d 376, 384-85 (8th Cir. 1953) (finding that Congress created substantive rights in parties to labor contracts when adopting the LMRA); Textile Workers Union v. Arista Mills Co., 193 F.2d 529, 533 (4th Cir. 1951) (same); Shirley-Herman Co. v. International Hod Carriers, Local 210, 182 F.2d 806, 809 (2d Cir. 1950) (same).

[35] *Lincoln Mills*, 353 U.S. at 451. The *Lincoln Mills* Court cited with approval Textile Workers Union v. American Thread Co., 113 F. Supp. 137 (D. Mass. 1953). *Lincoln Mills*, 353 U.S. at 451. The *American Thread* court ruled that Congress intended for § 301(a) to authorize federal law remedies, including specific enforcement of arbitration clauses. *American Thread*, 113 F. Supp. at 141; *see also* Avco Corp. v. Aero Lodge No. 735, 390 U.S. 557, 560 (1968) (holding § 301(a) action in state court was controlled by federal substantive law); Humphrey v. Moore, 375 U.S. 335, 342-44 (1964) (same).

[36] *Lincoln Mills*, 353 U.S. at 452-56. After analyzing the legislative history of the LMRA, the *Lincoln Mills* Court concluded that the Act's proponents wished to promote the inclusion of arbitration clauses in collective bargaining agreements. *Id.* at 453-54. The Court further construed the congressional documents to mean that Congress wanted § 301(a), in addition to conferring jurisdiction, to authorize federal courts to enforce labor contracts. *Id.* at 455. In fact, the Court found, Congress preferred a policy that placed sanctions behind arbitration agreements. *Id.* at 456. *Contra* Red Cross Line v. Atlantic Fruit Co., 264 U.S. 109, 121 (1924) (discussing common law rule that courts lack authority to enforce executory arbitration agreements). In a dissenting opinion to *Lincoln Mills*, Justice Frankfurter maintained that the complete legislative background revealed that § 301(a) was, in fact, nothing more than a procedural clause conferring jurisdiction on federal courts. *Lincoln Mills*, 353 U.S. at 467.

that federal substantive law for section 301(a) cases should come from the LMRA itself or be shaped from the policy behind the Act.[37] The Court also found that state law could be applied if it was compatible with federal policy,[38] but that it would be absorbed into federal law.[39] Finally, the Court formally affirmed the constitutionality of the LMRA.[40]

With federal law tightly woven into the fabric of American labor law through *Jones & Laughlin* and *Lincoln Mills*, the stage was set for the first landmark federal labor law preemption case, *San Diego Building Trades Council v. Garmon.*[41] The Supreme Court had to weigh state labor laws against NLRA section 7, which granted employees the right to organize, and section 8, which defined unfair labor practices[42] in disputes between unions[43] and employers.[44] The Court described the danger of conflicting labor laws, noting that Congress had entrusted

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The United States Supreme Court had earlier ruled that neither the text of § 301 nor its legislative history justified the use of federal substantive law. Association of Westinghouse Salaried Employees v. Westinghouse Elec. Corp., 348 U.S. 437, 441-49 (1955). The *Lincoln Mills* Court did not overrule this holding, but sought to distinguish it factually. *Lincoln Mills*, 353 U.S. at 456.

[37] *Lincoln Mills*, 353 U.S. at 457. *See generally* Mendelssohn, *Enforceability of Arbitration Agreements Under Taft-Hartley Section 301*, 66 YALE L.J. 167, 172-94 (1956) (discussing appropriate law in § 301 suits).

[38] *Lincoln Mills*, 353 U.S. at 457.

[39] *Id.*

[40] *Id.* The *Lincoln Mills* Court found that the Act was authorized by the commerce clause. *Id.* It also ruled that it was proper under judicial power extending to cases "arising under . . . the laws of the United States . . . ." *Id.* (quoting U.S. CONST. art. III, § 2, cl. 1).

[41] 359 U.S. 236 (1959). Federal preemption is derived from the supremacy clause of the United States Constitution. Wheeler & Brown, *Federal Preemption of State Wrongful Discharge Action*, 8 INDUS. REL. L.J. 1, 5 (1986). "This Constitution, and the Laws of the United States . . . shall be the supreme Law of the Land." U.S. CONST. art. VI, cl. 2. Courts long have recognized that federal law preempts state law. *E.g.*, Gibbons v. Ogden, 22 U.S. (9 Wheat.) 1, 189-222 (1824) (holding that congressional power under commerce clause supersedes state's regulation of ships traveling interstate).

[42] *Garmon*, 359 U.S. at 241-42. Unions picketed a company in an attempt to persuade it to accept a proposed labor contract. *Id.* at 237. The company filed a complaint with the NLRB, but the Board maintained it lacked jurisdiction. *Id.* at 238. On appeal, the California Supreme Court found the picketing to be a tort based on unfair labor practices and a violation of state law. *Id.* at 239. Employees have the right to organize. NLRA § 7, 29 U.S.C. § 157 (1982). The NLRA spells out in great detail unfair labor practices of employers. NLRA § 8, 29 U.S.C. § 158 (1982).

[43] *Garmon*, 359 U.S. at 237.

[44] *Id.* The employers were co-partners who sold lumber and other material in California. *Id.*

the nation's labor policy to a single, centralized agency, the NLRB.[45] State actions were therefore preempted by federal law in NLRA suits, according to the Court,[46] when the state power interfered with industrial policy as set by Congress.[47] The Court found, however, that an exception to federal preemption arose when the regulated activity was virtually outside the scope of the LMRA.[48] The Court also excepted local regulations that affected deeply entrenched local interests in the absence of congressional mandates for preemption.[49] The Court speci-

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[45] *Id.* at 242. The Court found that Congress, in creating the NLRB, signaled its intention to create a national labor policy administered by a specialized agency using uniform procedures. *Id.* at 242-43 (quoting Garner v. Teamsters Union, 346 U.S. 485, 490-91 (1953)). The Court stated that the existence of the NLRB and its administration of uniform procedures demonstrated Congress' intention to avoid the confusion caused by conflicting state and federal laws and contradictory remedies. *Id.*

[46] *Id.* at 243. A state law is preempted if Congress intended for federal law to control. Malone v. White Motor Corp., 435 U.S. 497, 504 (1978) (quoting Retail Clerks v. Schermerhorn, 375 U.S. 96, 103 (1963)). *See generally* Comment, *NLRA Preemption of State Wrongful Discharge Claims*, 34 HASTINGS L.J. 635, 641-53 (1982-83)(discussion of federal preemption in collective bargaining and wrongful discharge actions).

[47] *Garmon*, 359 U.S. at 243. The Court stood by its earlier decision in Guss v. Utah Labor Relations Bd., 353 U.S. 1 (1956), which held that states did not gain jurisdiction over NLRA cases when the NLRB declined to exercise jurisdiction. *Garmon*, 359 U.S. at 246. In *Guss*, a union filed a complaint with the NLRB and Utah Labor Relations Board accusing an employer of engaging in unfair labor practices under § 8 of the NLRA. *Guss*, 353 U.S. at 5. The NLRB declined jurisdiction. *Id.* at 5. The *Guss* Court ruled that the Utah Board had jurisdiction only if it entered an agreement under § 10(a) of the NLRA, in which the NLRB ceded jurisdiction. *Id.* at 9. This section of the NLRA provided:

> (a) The Board is empowered, as hereinafter provided, to prevent any person from engaging in any unfair labor practice (listed in section 158 of this title) affecting commerce. This power shall not be affected by any other means of adjustment or prevention that has been or may be established by agreement, law, or otherwise: Provided, That the Board is empowered by agreement with any agency of any State or Territory to cede to such agency jurisdiction over any cases in any industry (other than mining, manufacturing, communications, and transportation except where predominantly local in character) even though such cases may involve labor disputes affecting commerce, unless the provision of the State or Territorial statute applicable to the determination of such cases by such agency is inconsistent with the corresponding provision of this subchapter or has received a construction inconsistent therewith.

NLRA § 10 (a), 29 U.S.C. § 160 (1982).

[48] *Garmon*, 359 U.S. at 243. The Court cautioned that the NLRA preemption was not so encompassing that it eviscerated the federalism doctrine of shared power between states and the federal government. *Id.*; *see* International Ass'n of Machinists v. Gonzales, 356 U.S. 617, 618-20 (1958) (allowing state action for reinstatement in union because federal law did not undertake protection of membership in union).

[49] *Garmon*, 359 U.S. at 244; *see* New York Tel. Co. v. New York State Dep't of Labor, 440 U.S. 519, 533-40 (1979) (excepting state statute governing unemployment

fied that state regulations were superseded when they controlled activities protected by section 7[50] or barred by section 8[51] of the NLRA.[52] Stating that it was not always apparent whether an activity was governed by either section,[53] the *Garmon* Court ruled that state courts, as well as federal courts, should defer to the NLRB when pondering an activity "arguably subject" to either section.[54] The Court reasoned that exclusive NLRB jurisdiction was necessary to prevent state laws from conflicting with national labor policies.[55] The *Garmon* Court left undisturbed prior cases recognizing state remedies for violence and imminent threats to public order.[56] The Court found that such claims exemplified actions that survived because they were based on strong local

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compensation); Malone v. White Motor Corp., 435 U.S. 497, 514 (1978) (excepting state statute concerning pension plans). *See generally* Lesnick, *Preemption Reconsidered: The Apparent Reaffirmation of* Garmon, 72 COLUM. L. REV. 469, 481-82 (1972) (listing of state regulations spared preemption).

[50] *Garmon*, 359 U.S. at 245. Section 7 guarantees the rights of workers to organize. LMRA § 7, 29 U.S.C. § 157 (1982).

[51] *Garmon*, 359 U.S. at 245. Section 8 bars unfair labor practices. LMRA § 8, 29 U.S.C. § 158 (1982).

[52] *Garmon*, 359 U.S. at 245. The *Garmon* Court ruled that the NLRB, not the state or federal courts, had primary jurisdiction over disputes concerning §§ 7 and 8. *Id.*

[53] *Id.* at 244.

[54] *Id.* at 244-45; *see, e.g.*, Amalgamated Ass'n of Street Employees v. Lockridge, 403 U.S. 274, 285-91 (1971) (giving NLRB exclusive jurisdiction over disputed discharge clause in labor contract); Mobile Mechanical Contractors Ass'n v. Carlough, 664 F.2d 481, 487-88 (5th Cir. 1981) (granting NLRB jurisdiction over union strike to obtain trust funds). *See generally* Cox, *Recent Developments in Federal Labor Law Preemption*, 41 OHIO ST. L.J. 277, 281-91 (1980) (overview of NLRB jurisdiction over activities arguably subject to §§ 7 and 8).

[55] *Garmon*, 359 U.S. at 246. The Court stated that if states exercised jurisdiction over activities "potentially" subject to federal regulations, the stage would have been set for state court rulings that contradicted national labor policy. *Id.*

However, it has been argued that a mere showing that an activity was arguably prohibited by § 8 was insufficient to justify exclusive NLRB jurisdiction. *Id.* The Supreme Court has sustained state court jurisdiction to award compensation for mass picketing or violence. Cox, *supra*, note 54, at 281. On the other hand, the Supreme Court was justified in giving exclusive jurisdiction to the NLRB for activities arguably protected by § 7 because of the states' historical antipathy to unions and the expertise of the NLRB. *Id.* at 287-88.

[56] *Garmon*, 359 U.S. at 247; *see* UAW v. Russell, 356 U.S. 634, 640-46 (1958) (recognizing state action against union for violence on picket line); United Constr. Workers v. Laburnum Constr. Corp., 347 U.S. 656, 663-69 (1954) (allowing state action for threatened violence against employer). *But see* Garner v. Teamsters Union, 346 U.S. 485, 487-91 (1953) (granting NLRB exclusive jurisdiction over suit against union for picketing).

interests and did not conflict with any congressional direction.[57]

After recognizing preemption under the NLRA in *Garmon*, the Supreme Court went one step further and expressly provided for preemption in LMRA section 301(a) suits over breach-of-labor-contract suits in *Local 26, Teamsters Union v. Lucas Flour Co.*[58] The Court held that section 301(a) preempted state law in an action by an employer which claimed in state court that it deserved to recover business losses caused by a strike conducted because an employee had been discharged.[59] Ruling that the state court properly exercised jurisdiction, the *Lucas Flour* Court held that federal law in section 301(a) suits, including those in state courts, superseded contradictory state laws.[60] The Court reasoned that *Lincoln Mills* mandated uniform labor law,[61] a goal that could be achieved only if issues raised in section 301 (a)

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[57] *Garmon*, 359 U.S. at 247. Another line of cases following *Garmon* established a separate theory of preemption. Gould, *When State and Federal Laws Collide: Preemption—Nightmare or Opportunity?*, 9 INDUS. REL. L.J. 4, 5 (1987). This preemption doctrine arose in International Ass'n of Machinists v. Wisconsin Employment Relations Comm'n, 427 U.S. 132 (1976). Gould, *supra*, at 5. Under this doctrine, a state action is disallowed if it would unconstitutionally give too much power to either labor or management. *Id.* It is irrelevant that the activity is not covered by the NLRA. *Id.*; *see* Local 20, Teamsters Union v. Morton, 377 U.S. 252, 256-61 (1964) (preempting state action against union for peaceful encouragement of customers to discontinue patronage of plant). *See generally* Comment, *The Unfairness of Federal Preemption of State Law Exceptions to the Employment-At-Will Rule and the Need for a Uniform National Remedy for Wrongful Discharge*, 55 MISS. L.J. 517, 526-30 (1985) (outline of exceptions to *Garmon* preemption); Note, *NLRA Preemption of State Law Actions for Wrongful Discharge in Violation of Public Policy*, 19 U. MICH. J.L. REF. 441, 447-50 (1986) (effect of *Garmon* on preemption).

[58] 369 U.S. 95, 102-04 (1962).

[59] *Lucas Flour*, 369 U.S at 97. The union had gone on strike in an attempt to force the employer to rehire a discharged employee. *Id.* The employer, in turn, successfully sued in a Washington state court for business losses stemming from the strike. *Id.*

[60] *Id.* at 101. State and federal courts share jurisdiction over § 301(a) suits. Charles Dowd Box Co. v. Courtney, 368 U.S. 502, 505-14 (1962).

[61] *Lucas Flour*, 369 U.S. at 102. The *Lucas Flour* Court stated that in *Dowd Box* it had simply acted upon the supposition that state courts applied federal law in § 301(a) litigation. *Id.* The *Lucas Flour* Court, however, stated that because there was no claim that the state and federal law differed in *Dowd Box*, it had no need to address the issue of state-versus-federal law in *Dowd Box*. *Id.* On the other hand, the Washington state court in *Lucas Flour* expressly held that state substantive law applied, despite assertions by the union that it had not violated the labor contract under federal law. *Id.* The *Lucas Flour* Court held that even while federal law supplanted state law, the union still violated the contract under federal law, and judgment for the employer was affirmed. *Id.* at 102-03; *see* Walsh v. Schlecht, 429 U.S. 401, 407-08 (1977) (preempting state action to enforce labor contract clause establishing trust fund).

suits were adjudicated under federal law.[62] If conflicting state and federal law were applied to enforcement of labor contracts, the Court warned, the resulting confusion would frustrate and possibly deter the adoption of labor contracts.[63] Furthermore, the Court stated, a reduction in the number of labor contracts would undermine the national policy of promoting the adoption of arbitration clauses in labor contracts to encourage peaceful resolutions of labor troubles.[64]

More recently, federal preemption under the LMRA was again broadened in *Allis-Chalmers Corp. v. Lueck*.[65] The Supreme Court confronted a state bad-faith action which a worker had initiated against his employer and group insurer[66] without first resorting to a grievance procedure in his labor contract.[67] Analyzing the claim under section 301(a), the Court began its inquiry by noting that a local law in such cases would be sustained unless it contradicted federal law, interfered with national labor policies, or lay within the scope of law reserved by Congress for federal regulation.[68] The Court recited the public policies used to justify the *Lucas Flour* holding that section 301 preempted breach-of-labor-contract suits.[69] It then reasoned that those

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[62] *Lucas Flour*, 369 U.S. at 103. *Lincoln Mills* required that federal substantive law be used in § 301 suits. *See supra* note 32 and accompanying text.

[63] *Lucas Flour*, 369 U.S. at 103. The Court stated that confusion as to rights under the conflicting laws would make the negotiation of labor contracts more difficult and lengthy, as each party sought to fashion provisions with identical meanings under the two systems of law. *Id.* Even after adoption of a contract, disputes over its construction would become more protracted if the contract were interpreted under separate sets of law. *Id.* at 103-04.

[64] *Id.* at 104-05; *see also* United Steelworkers v. American Mfg., 363 U.S. 564, 568-69 (1960) (finding that courts should enforce arbitration clauses in contracts to settle labor disputes); United Steelworkers v. Warrier & Gulf Navigation Co., 363 U.S. 574, 583-85 (1960) (same); United Steelworkers v. Enterprise Wheel & Car Corp., 363 U.S. 593, 596 (1960) (same). The three preceding steelworkers' cases, called *The Steelworkers Trilogy*, made arbitration a national goal. Stone, *supra* note 12, at 1528.

The *Lucas Flour* Court found that the grievance procedure for striking workers in *Lucas Flour* should have been enforced. *Lucas Flour*, 369 U.S. at 106.

[65] 471 U.S. 202 (1985).

[66] *Allis-Chalmers*, 471 U.S. at 205-06. The employee, Lueck, periodically received disability payments from the Aetna Life and Casualty Co., which was the group insurance carrier for Lueck's employer, Allis-Chalmers. *Id.* at 205. Injured in a nonoccupational accident in 1981, Lueck claimed Allis-Chalmers periodically instructed Aetna to discontinue disability payments. *Id.* Lueck filed a state bad-faith claim in Wisconsin state court. *Id.* at 206.

[67] *Id.* at 206. The contract provided for a four-step grievance procedure capped by binding arbitration. *Id.* at 204.

[68] *Id.* at 209 (quoting Malone v. White Motor Corp., 435 U.S. 497, 504 (1978)).

[69] *Id.* at 210. Conflicting state and federal law would hamper negotiation of labor

same policies dictated that federal law must supersede state actions of all types, including torts, which require an interpretation of labor contracts.[70] The Court specified that state-law tort claims "inextricably intertwined" with the language of a contract were preempted by federal law under section 301(a).[71] The Court concluded its analysis by stating that preemption of a tort claim such as Lueck's was crucial to preserving arbitration as the central vehicle for settling labor disputes.[72] The voluntary inclusion of an arbitration clause in a labor contract stemmed from a federal right, the Court stated.[73] Therefore, it held, federal law should be available to enforce an arbitration clause, even in a tort suit.[74] The Court cautioned that its ruling did not require preemption in all state-law suits related to labor contracts, but that preemption was reserved only for those claims that were substantially dependent on terms in a contract.[75] In those cases, the Court stated, claims must be treated as section 301(a) actions[76] or must be dismissed as preempted by federal law.[77]

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contracts. *See supra* note 63 and accompanying text.

[70] *Allis-Chalmers*, 471 U.S. at 211. The Court emphasized the importance of contract uniformity, which can be achieved by use of federal law. *Id.* This applies to both breach-of-contract and tort claims. *Id.*; *see* Bowen v. United States Postal Serv., 459 U.S. 212, 224-25 (1983) (finding that relationships in labor contracts must be controlled by federal law).

[71] *Allis-Chalmers*, 471 U.S. at 213. The *Allis-Chalmers* Court found that Lueck's tort claim was dependent on the contract and should consequently be preempted. *Id.* at 216. *See generally* Wheeler and Browne, *Federal Preemption of State Wrongful Discharge Actions*, 8 INDUS. REL. L.J. 1, 26-28 (1986) (review of *Allis-Chalmers*' analysis of Lueck's tort and its relationship to his contract).

[72] *Allis-Chalmers*, 471 U.S. at 219.

[73] *Id.*

[74] *Id.*

[75] *Id.*; *e.g.*, Baldracchi v. Pratt & Whitney Aircraft Div., 814 F.2d 102, 107 (2d Cir. 1987), *cert. denied*, 108 S. Ct. 2819 (1988) (refusing to preempt retaliatory discharge claim because state statute authorizing claim specified it was not to be decided by reference to labor contract). *But see* Johnson v. Hussmann Corp., 805 F.2d 795, 797 (8th Cir. 1986) (preempting retaliatory discharge claim because it alleged violation of collective bargaining agreement).

[76] *Allis-Chalmers*, 471 U.S. at 220; *see, e.g.*, Avco Corp. v. Aero Lodge 735, 390 U.S. 557, 560-62 (1968) (treating employer's suit to enforce a no-strike clause in labor contract as § 301 claim).

[77] *Allis-Chalmers*, 471 U.S. at 221. When federal law applies to a case, the nation's labor policy demands that an aggrieved employee must attempt to use mutually agreed-upon grievance procedure. Republic Steel Corp. v. Maddox, 379 U.S. 650, 652-53 (1965). The *Republic Steel* Court found that Congress adopted arbitration as the preferred method of resolving labor disputes in § 203(d) of the LMRA. *Republic Steel*, 379 U.S. at 653. Section 203(d) provides that any method adopted by parties to settle grievances is the desired system for resolving disputes. LMRA § 203(d), 29 U.S.C. § 173(d) (1982); *see*

In the instant case, the United States Supreme Court ruled that the retaliatory discharge suit should not be preempted,[78] because state law is superseded under section 301(a) only when the collective bargaining agreement must be interpreted.[79] The Court began its analysis by reasoning that since federal law in section 301(a) suits preempts any state remedy that turns on an interpretation of a collective bargaining agreement,[80] federal labor law must supplant retaliatory discharge suits that depend on an interpretation of an agreement covering employment.[81] The Court determined that the retaliatory discharge action involving workers' compensation claims[82] required no interpretation of agreements, because Illinois law did not require plaintiffs and defendants in such actions to prove the facts of bargaining agreements.[83] The Court further reasoned that since some state actions, such as an Illinois retaliatory discharge, can be resolved without reference to bargaining agreements,[84] then preemption under section 301(a) is inappropriate in such instances, even when grievance procedures covering employees and the state actions revolve around identical factual inquiries.[85]

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also Buffalo Forge Co. v. United Steelworkers, 428 U.S. 397, 411-12 (1976) (prohibiting injunction by federal district court against strike until employer and union have strike settled in arbitration).

[78] *Lingle*, 108 S. Ct. at 1885. The Court stated in dictum that its conclusion furthered its previously stated policy of promoting the workers' use of arbitration to secure rights guaranteed in collective bargaining agreements. *Id.* at 1884. The Court emphasized that judges remain bound to apply state law to labor disputes only when collective bargaining agreements need not be scrutinized. *Id.* The Court further stated that its ruling faithfully adhered to its prior findings that state and federal law, in addition to bargaining agreements, support workers' substantive rights. *Id.* at 1884-85.

[79] *Id.*

[80] *Id.* at 1881. The Court relied on *Lucas Flour*'s mandated preemption in such situations. *Id.*

[81] *Id.* The Court explained that application of state law would create undesirable inconsistencies. *Id.* In particular, labor law would differ from state to state. *Id.*

[82] *Id.* at 1882 (quoting Horton v. Miller Chemical Co., 776 F.2d 1351, 1356 (7th Cir. 1985), *cert. denied*, 475 U.S. 1122 (1986). The plaintiff must prove both that he was discharged or threatened with discharge and that the employer's motive was to discourage the use of Illinois workers' compensation laws. *Id.* An employer defends in such a suit by showing a nonretaliatory justification for termination. *Id.*

[83] *Id.*

[84] *Id.* at 1883.

[85] *Id.* The Court found that the LMRA is intended only to guarantee that federal law will govern the interpretation of collective bargaining agreements; it does not bar state remedies for violations of workers' substantive rights when the action requires no interpretation of these agreements. *Id.* Rejecting the reasoning of the lower courts, the Court ruled that if the state action does not require a construction of the agreement, it should be allowed to be pursued even when it involves a factual analysis identical to one

The United States Supreme Court appeared to push federal law to a near monopolization of labor regulations through a series of landmark decisions beginning with *Jones & Laughlin* in 1937.[86] *Jones & Laughlin* moved the federal government from its laissez faire approach toward employer-employee relations to a very visible role of policing management's treatment of workers through the NLRB.[87] The Court extended the scope of federal labor law in *Lincoln Mills* by inviting courts to shape a body of federal law to enforce collective bargaining agreements, including arbitration clauses.[88] *Garmon* further strengthened federal law at the expense of state law by ordering NLRB jurisdiction over activities arguably subject to sections 7 and 8 of the NLRA.[89] The *Lucas Flour* Court again chipped away at state labor law by holding that federal law should prevail in suits falling under section 301(a) of the LMRA.[90] Finally, the *Allis-Chalmers* decision provided for preemption under section 301(a) in any suits, including breach-of-contract actions and torts, that involve an interpretation of the labor contract.[91]

The instant case, *Lingle*, refined the *Allis-Chalmers* holding by specifying that no section 301(a) preemption was warranted unless construction of the labor contract was essential to settling the state law action.[92] Carrying its rationale further, the *Lingle* Court found that preemption was unwarranted even in instances where the state action required a factual inquiry identical to the one under a grievance procedure but where the state action could be litigated without reference to the grievance procedure.[93] The *Lingle* departure from federal preemption raises an obvious question: Is the Supreme Court rolling back the fifty-year-old ascendancy of federal labor policy, or does *Lingle* merely represent a minor stumbling block on a continuous judicial path toward an all-encompassing federal labor law?[94] Such a question may be difficult to answer, especially since *Lingle* was based on public policies that have long underpinned the Court's major labor law preemption

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necessary under an enforcement procedure in an applicable agreement. *Id.* In short, the Court concluded that the state claim is "independent" of the agreement with regard to triggering preemption. *Id.*

[86] *See supra* note 17 and accompanying text.

[87] *See supra* notes 17-29 and accompanying text.

[88] *See supra* notes 31-37 and accompanying text.

[89] *See supra* notes 50-55 and accompanying text.

[90] *See supra* notes 60-62 and accompanying text.

[91] *See supra* notes 70-77 and accompanying text.

[92] *See supra* notes 79-81 and accompanying text.

[93] *See supra* note 85 and accompanying text.

[94] *See supra* text accompanying notes 86-91.

cases.[95] Specifically, the *Lingle* Court indicated that it hoped to avoid inconsistent state and federal labor laws[96] and wished to promote arbitration.[97] Despite the Supreme Court's proclaimed faithfulness to time-honored policies used to promote federal preemption, however, *Lingle*'s restriction on the scope of preemption should encourage state actions that parties were reluctant to bring after *Allis-Chalmers*.[98] In that sense, *Lingle* does represent a slight deviation from the Court's preference for federal law, but the change in course is too slight to justify predictions of an imminent rollback in the pervasiveness of federal labor law.[99]

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[95] *See supra* note 80 and accompanying text.
[96] *See supra* note 81 and accompanying text.
[97] *See supra* note 80 and accompanying text.
[98] *See supra* notes 65, 68-70 and accompanying text.
[99] *See supra* notes 78-79, 85 and accompanying text.

Insurance — Arson — Defense of Civil Arson Is Equivalent to Alleging Fraud and Must Be Proved by Clear and Convincing Evidence

Plaintiff[1] filed suit in the Chancery Court of Lee County, Mississippi, seeking a declaratory judgment[2] that it was not liable under a fire insurance policy[3] because of arson[4] by defendants.[5] At trial, the circuit court[6] required the plaintiff to prove its charge of arson by a preponderance of the evidence.[7] The jury found in favor of the plaintiff, and the court entered judgment voiding coverage of the fire insurance policy.[8] The defendant moved for a judgment notwithstanding the verdict or, in the alternative, for a new trial, both of which were denied by the court.[9] On appeal, the Supreme Court of Mississippi, *held*, re-

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[1] The plaintiff was Allstate Insurance Company. McGory v. Allstate Ins. Co., 527 So. 2d 632, 634 (Miss. 1988).

[2] *Id.* The plaintiff sought a declaratory judgment under Miss. R. Civ. P. 57. *McGory*, 527 So. 2d at 634.

[3] *McGory*, 527 So. 2d at 634. The insurance policy covered certain rental property that was located on Highway 6 in Nettleton, Mississippi. *Id.* at 633-34.

[4] *Id.* at 633. The house on the insured property was substantially damaged by fire. *Id.* The defendants conceded that the fire was of incendiary origins, but they argued that Allstate could not prove that either defendant was responsible for it. *Id.* at 634.

[5] *Id.* at 634. Bobby and Dorothy McGory were the defendants against whom arson was alleged by Allstate. *Id.* Allstate also named G.J. Gravlee, d/b/a Gravlee Lumber Company, Nettleton Building Supply Corporation, and Steve Hudson as defendants, all of whom were creditors of the McGorys. *Id.* The defendants filed a counterclaim against the plaintiff, asserting that the loss was within the coverage of the policy and demanding payment. *Id.*

[6] *Id.* The case was transferred from the chancery court to the Circuit Court of Lee County, where it was tried before a civil jury. *Id.*

[7] *Id.* at 633.

[8] *Id.* at 634. Nine jurors voted in favor of Allstate, and three voted in favor of the McGorys. *Id.*

[9] *Id.* The McGorys claimed that the jury was improperly instructed as to the standard of proof necessary to find them guilty of civil arson. *Id.* at 638. The defendants also argued that the circuit court had committed several other errors. *Id.* One alleged error asserted by the defendants was the granting of contradictory instructions on the issue of whether arson on the part of one co-insured eradicated the right of the other co-insured to collect under an insurance policy. *Id.* Another assignment of error stipulated by the McGorys was the trial court's denial of an instruction disallowing the use of circumstantial evidence to prove their culpability. *Id.* at 639. The McGorys assigned several other evidentiary errors not explicitly discussed in the instant case. *Id.*

versed and remanded.[10] When an insurer seeks to avoid coverage under a fire insurance policy by charging that the insured has committed civil arson, the charge of arson is equivalent to alleging fraud, and the insurer must therefore prove each element of its claim by clear and convincing evidence. *McGory v. Allstate Insurance Co.*, 527 So. 2d 632 (Miss. 1988).

It has been a well settled principle in all American jurisdictions that arson or willful incendiarism is an affirmative defense to an action on a fire insurance policy.[11] The burden of proof with respect to the arson defense is borne by the insurer.[12] Although jurisdictions vary on the requisite elements for proving willful incendiarism, most courts require that, in order to prevail on its affirmative defense of arson, an insurer must prove three elements: (1) a fire incendiary in nature; (2) opportunity of the insured or procurement of another by the insured to commit the incendiary act; and (3) motive on the part of the insured to cause the fire.[13]

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[10] *Id.* at 640. The Supreme Court of Mississippi reversed and remanded because of an improper jury instruction. *Id.* at 636-38. The court held that the denial of the judgment notwithstanding the verdict was correct, because a reasonable juror could have found the McGorys guilty of arson even under the clear and convincing evidence standard. *Id.* at 637. As to the motion for a new trial, the court found no clear error in the denial by the trial court, and judgment on the accuracy of the refusal to grant a new trial was thereby avoided. *Id.* at 637-38. On other assignments of error raised by the McGorys, the court stated that the contradictory instructions on the issue of whether arson committed by one co-insured might be imputed to another co-insured were inadequate. *Id.* at 638. Following many other jurisdictions, the court held that in the absence of an insurance policy clause which excluded coverage to one co-insured because of deliberate wrongful acts committed by another co-insured, an innocent spouse or business partner insured might recover on the policy. *Id.* On whether circumstantial evidence was applicable to prove the guilt of the insureds, the supreme court recognized that such evidence was admissible to prove arson on the part of the defendant but was to be tabulated according to the clear and convincing evidence formula established by the court. *Id.* at 639.

[11] Kavanagh, *Proof of Arson Fraud in Civil Litigation*, 35 FED. INS. COUNS. Q. 311, 313-14 (1984) (discussing arson as complete defense to action on fire insurance policy); *see* Note, *Arson: Defense of a Fraudulent Property Insurance Claim*, 35 DRAKE L. REV. 831, 834-35 (1986-87) (discussing arson as affirmative defense to action on fire insurance policy).

[12] Note, *supra* note 11, at 834 (discussing burden of proof when affirmative defense of arson is raised). *See generally* 19 G. COUCH, COUCH ON INSURANCE § 79:477 (2d ed. 1983) (burden of proof for civil arson rests on insurer).

[13] Burress v. Standard Fire Ins. Co., 642 F. Supp. 62, 66-67 (N.D. Miss. 1986); *see* Don Burton, Inc. v. Aetna Life & Casualty Co., 575 F.2d 702, 707 (9th Cir. 1978) (under California law insurer must prove that fire was of incendiary origin, that insured caused or participated in it, and that insured had motive to set fire); Mele v. All-Star Ins. Corp., 453 F. Supp. 1338, 1341 (E.D. Pa. 1978) (elements of civil arson defense under Pennsyl-

The appropriate standard of proof by which these elements must be proved has been the subject of some debate.[14] It was an English court that first discussed the issue of the applicable standard of proof in civil suits when an insurer claimed arson as a defense to its liability on a fire insurance policy.[15] In 1823, the case of *Thurtell v. Beaumont*[16] involved an insurance company that raised the defense that the insured had willfully set fire to the premises.[17] The court held that, in order to return a verdict against the plaintiff, the jury must apply the criminal standard of proof and must therefore be satisfied beyond a reasonable doubt that the insured had committed arson.[18] On the other hand, most of the courts in the United States which first addressed the issue of the appropriate standard of proof in early civil arson cases rejected the reasonable doubt standard.[19] Instead of adopting the crimi-

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vania law were: (1) an incendiary fire, (2) motive by insured to destroy property, and (3) circumstantial evidence connecting insured to fire); Godwin v. Farmers Ins. Co. of Am., 129 Ariz. 416, 631 P.2d 571, 574 (Ct. App. 1981) (insurer had burden to prove that fire was of incendiary origin and insured was responsible for it); George v. Travelers Indem. Co., 81 Mich. App. 106, 265 N.W.2d 59, 62 (1978) (insurer had burden to prove insured set fire to building or caused it to be set on fire). *See generally*, Kavanagh, *supra* note 11, at 315 (listing three elements of arson defense as motive, opportunity and incendiarism); Note, *supra* note 11, at 835 (explaining that insurer must prove that fire was of incendiary nature and insured caused or procured fire to establish arson defense).

[14] Comment, *Arson Fraud: Criminal Prosecution and Insurance Law*, 7 FORDHAM URB. L.J. 541, 578-86 (1979) (discussing standard of proof in civil arson cases)[hereinafter Comment, *Arson Fraud*]. *See generally*, Polk, *Arson and Related Defenses in Civil Actions Under Fire Insurance Policies*, 1967 INS. L.J. 645, 646 (same); Comment, *Avoiding Liability in an Arson Case: Suggestions for the Defense*, 47 UMKC L. REV. 389, 396-99 (1979) (same)[hereinafter Comment, *Avoiding Liability*].

[15] Groom, *Proof of Crime in a Civil Proceeding*, 13 MINN. L. REV. 556, 562 (1929) (discussing origin of application of criminal standard of proof in civil suits).

[16] 1 Bing. 339, 130 Eng. Rep. 136 (1823).

[17] *Thurtell*, 1 Bing. at 340. The defendant insurance company urged that in civil cases it was not necessary to meet the same burden as that applied in criminal cases. *Id.* The burden pleaded by the defendant was that the evidence merely satisfy the jury as to the plaintiff's involvement in the burning of the premises, whether incendiary or negligent. *Id.*

[18] *Id.* Although English courts adopted the doctrine of applying the criminal standard of proof in a civil proceeding when libel or slander was alleged, the *Thurtell* principle of requiring arson to be proved beyond a reasonable doubt never gained support in England. Kane v. Hibernia Ins. Co., 39 N.J.L. 697, 704 (1877); *see* Annotation, *Reasonable Doubt Rule as Applicable to Evidence in Civil Case of Facts Amounting to Felony or Misdemeanor*, 124 A.L.R. 1378, 1379 (1939) (discussing rule in England applying reasonable doubt standard to evidence in civil suit when facts constituted crime). *See generally* Groom, *supra* note 15, at 562 (discussing *Thurtell* doctrine in England).

[19] Groom, *supra* note 15, at 567; *see* Carlwitz v. Germania Fire Ins. Co., 5 F. Cas. 87, 88 (C.C.D.N.J. 1883) (No. 2,415a) (rejected criminal standard in civil arson case and ap-

nal standard, American courts typically considered whether the clear and convincing evidence standard or the ordinary preponderance standard was appropriate in civil arson cases.[20]

The Court of Appeals of Maryland considered this issue when an insurer claimed arson as a defense to its liability on a fire insurance policy in *Rent-A-Car Co. v. Globe & Rutgers Fire Insurance Co.*[21] The plaintiff in *Rent-A-Car* sought to collect on a fire insurance policy cov-

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plied preponderance standard); Mack v. Lancashire Ins. Co., 4 F. 59, 63 (C.C.D. Mo. 1880) (rejected criminal standard when defendant insurance company claimed arson as defense and held clear preponderance as appropriate standard); Sibley v. St. Paul Fire & Marine Ins. Co., 22 F. Cas. 60, 61 (C.C.N.D. Ill. 1878) (No. 12,830) (adopted preponderance standard to prove defense of civil arson); Scott v. Home Ins. Co., 21 F. Cas. 833, 834 (C.C.D. Mo. 1870) (No. 12,533) (evidence must clearly satisfy jury in order to prevail on defense of arson); Continental Ins. Co. v. Jachnichen, 10 Ind. 59, 10 N.E. 636, 639 (1887) (preponderance of evidence sufficient to maintain defense of arson); Aetna Ins. Co. v. Johnson, 74 Ky. (11 Bush) 587, 593 (1875) (same); Wightman v. Western Marine & Fire Ins. Co., 8 Rob. 442, 449 (La. 1844) (same); Schmidt v. New York Union Mut. Fire Ins. Co., 67 Mass. (1 Gray) 529, 532 (1854) (same); Monaghan v. Agricultural Fire Ins. Co., 53 Mich. 238, 18 N.W. 797, 805 (1884) (same); Thoreson v. Northwestern Nat'l Ins. Co., 29 Minn. 107, 12 N.W. 154, 154 (1882) (same); Marshall v. Thames Fire Ins. Co., 43 Mo. 586, 589 (1869) (same); American Mut. Ins. Co. v. Anderson, 33 N.J.L. 151, 152 (1868) (required civil arson to be proved by clear and satisfactory proof); Weir v. Aetna Ins. Co., 36 N.Y.S. 216, 217 (App. Div. 1895) (rejected criminal standard of proof and required defense of arson be proved by preponderance of evidence); Blackburn v. St. Paul Fire & Marine Ins. Co., 116 N.C. 821, 21 S.E. 922, 923 (1895) (same); First Nat'l Bank v. Commercial Union Assurance Co., 33 Or. 43, 52 P. 1050, 1054 (1898) (same); Somerset Co. Mut. Fire Ins. Co. v. Usaw, 112 Pa. 80, 4 A. 355, 357 (1886) (same); Bradish v. Bliss, 35 Vt. 326, 328 (1862) (same); Hart v. Niagara Fire Ins. Co., 9 Wash. 620, 38 P. 213, 219 (1894) (same); Simmons v. Insurance Co., 8 W. Va. 474, 498 (1875) (same); Washington Union Ins. Co. v. Wilson, 7 Wis. 147, 149 (1859) (same). *But see* Germania Fire Ins. Co. v. Klewer, 129 Ill. 599, 22 N.E. 489, 492 (1889) (reasonable doubt standard applied in insurance case where arson alleged); Butman v. Hobbs, 35 Me. 227, 232 (1853) (same); Lexington Ins. Co. v. Paver, 16 Ohio 324, 333 (1847) (same). The adoption of the criminal standard of proof in four of the previously cited civil arson cases was subsequently rejected. Abraham v. Baldwin, 52 Fla. 151, 42 So. 591, 594 (1906) (rejected application of criminal standard applied in *Schultz* and held civil arson be proved by preponderance of evidence); Behrens v. Germania Ins. Co., 58 Iowa 26, 11 N.W. 719, 720 (1882) (applied preponderance standard in civil arson case instead of reasonable doubt standard); Decker v. Somerset Mut. Fire Ins. Co., 66 Me. 406, 408 (1876) (rejected *Butman* criminal standard for preponderance standard in civil arson case); Bell v. McGinness, 40 Ohio St. 204, 206 (1883) (impliedly overruled criminal burden of proof applied in *Lexington* and applied preponderance standard).

[20] Comment, *Avoiding Liability*, *supra* note 14, at 396 (discussing standard of proof in civil arson cases as preponderance standard or clear and convincing standard but not beyond reasonable doubt); *see* Kavanagh, *supra* note 11, at 314 (discussing standard of proof in civil arson cases); Comment, *Arson Fraud*, *supra* note 14, at 579 (same).

[21] 171 Md. 249, 156 A. 847 (1931).

ering certain automobiles which were damaged by fire.[22] After a lower court decided in favor of the defendant insurance company, the plaintiff appealed.[23] On appeal, the plaintiff contended that there was no evidence legally sufficient to find it guilty of arson, and that it was therefore entitled to recovery.[24] The *Rent-A-Car* court decided the appropriate standard of proof for civil arson cases by first classifying arson as fraud.[25] Since fraud had to be proved by more than a preponderance of the evidence, the court held that the same standard was required in this civil arson case.[26] The court explained that people are presumed innocent of fraud or arson and that the evidence offered to prove such culpability must therefore overcome this presumption of innocence.[27] Basing its conclusion on the higher degree of protection accorded a party accused of fraud, the court held that when an insurer claims arson as a defense to its liability on a fire insurance policy, it must be proved by clear and satisfactory evidence.[28]

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[22] *Rent-A-Car*, 156 A. at 849.

[23] *Id.* The plaintiff contended that the trial court had instructed the jury improperly on the requisite standard of proof necessary to find it guilty of arson. *Id.* at 855. The trial court had stated:

> [B]y the phrase "preponderance of the evidence" mentioned . . . the law does not mean to indicate any particular degree of certainty to which the proof must go; it simply means that the evidence in favor of the defendant must, to the minds of the jury, be more weighty and more satisfactory than the evidence of the Plaintiff upon the same point.

Id.

[24] *Id.* at 849.

[25] *Id.* at 855. Although the court did not explicitly state that arson was fraud, it stipulated that " '[w]hen fraud or criminal conduct is imputed the decisions frequently declare that something more than a mere preponderance of evidence must be produced, and that the proof must be clear and satisfactory.' " *Id.* (quoting B. JONES, COMMENTARIES ON EVIDENCE § 195 (2d ed. 1926)).

[26] *Id.*

[27] *Id. See generally* Comment, *Arson Fraud*, *supra* note 14, at 582 (stating that even in civil suit, person is entitled to presumption of innocence of illegal acts); Comment, *Avoiding Liability*, *supra* note 14, at 396-97 (discussing standard of proof and presumption of innocence involved in civil arson cases when arson classified as fraud).

[28] *Rent-A-Car*, 156 A. at 855. The justification for requiring a higher degree of proof than the mere preponderance standard has been that arson amounts to fraud. Comment, *Arson Fraud*, *supra* note 14, at 582; *see, e.g.*, Carpenter v. Union Ins. Soc'y of Canton, Ltd., 284 F.2d 155, 162 (4th Cir. 1960) (applying South Carolina law, court held that fraud is never presumed and must be proved by clear and convincing evidence; therefore, arson must be proved by clear and convincing evidence); Hardware Mut. Ins. Co. v. Jacob Hieb, Inc., 146 F.2d 447, 452 (8th Cir. 1945) (applying South Dakota law, court held evidence to sustain charge of fraud by arson must be clear and convincing); Mize v. Harford Ins. Co., 567 F. Supp. 550, 551 (W.D. Va. 1982) (applying Virginia law, same holding); Hutt v. Lumbermens Mut. Casualty Co., 95 A.D.2d 255, 466 N.Y.S.2d 28, 30

The Supreme Court of Mississippi also required fraud to be proved by clear and convincing evidence in *Reily v. Crymes*.[29] In *Reily*, the defendant bond company claimed as a defense to its payment on a fiduciary bond that the guardian of an incompetent had fraudulently converted payments to his personal use.[30] The *Reily* court began its discussion of the standard of proof for fraud by acknowledging that in civil cases, courts render judgments based on reasonable probabilities.[31] The court held that when fraud is alleged, the evidence must be clear and convincing to establish that fraud has occurred.[32]

Although many jurisdictions have required that fraud be proved by clear and convincing evidence in civil suits,[33] most of those jurisdic-

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(1983) (same holding); Ziegler v. Hustisford Farmers' Mut. Ins. Co., 238 Wis. 238, 298 N.W. 610, 611-12 (1941) (same); *see also* Comment, *Avoiding Liability*, *supra* note 14, at 396 (discussing seriousness of allegation of arson as factor in application of clear and convincing evidence standard); Note, *supra* note 11, at 838-41 (discussing defenses of fraud and arson and requisite standard of proof). It should also be noted that the "clear and satisfactory" evidence standard applied in *Rent-A-Car* is the equivalent of the "clear and convincing" evidence standard and that the clear and convincing standard is somewhere between the preponderance of the evidence standard required in most civil cases and the criminal standard of "beyond a reasonable doubt." *See* C. MCCORMICK, EVIDENCE § 340 (3d ed. 1984) (discussing vernacular of clear and convincing evidence standard variations from state to state—" 'by clear and convincing evidence,' 'clear, convincing and satisfactory,' 'clear, cogent and convincing,' and 'clear, unequivocal, satisfactory and convincing.' "—and discussing generally clear and convincing evidence standard); *see also* McBaine, *Burden of Proof: Degrees of Belief*, 32 CALIF. L. REV. 242, 245-51 (1944) (discussing difference between preponderance standard, clear and convincing standard, and criminal standard; requirement that allegation be proved to be "highly probable"); Comment, *Arson Fraud*, *supra* note 14, at 579 (clear and convincing standard demands more or better evidence for jury to be persuaded than preponderance standard); Comment, *Avoiding Liability*, *supra* note 14, at 396 (clear and convincing burden is greater than that by preponderance of evidence but less than reasonable doubt standard).

[29] 176 Miss. 133, 168 So. 267 (1936).

[30] *Reily*, 176 Miss. at 137, 168 So. at 269.

[31] *Id.* at 146, 168 So. at 272.

[32] *Id.*; *see also* Haygood v. First Nat'l Bank, 517 So. 2d 553, 555 (Miss. 1987) (in Mississippi, fraud must be proved by clear and convincing evidence); Beck Enters., Inc. v. Hester, 512 So. 2d 672, 675 (Miss. 1987) (same); Cherry v. Anthony, Gibbs, Sage, 501 So. 2d 416, 420 (Miss. 1987) (same); Craft v. Craft, 478 So. 2d 258, 263 (Miss. 1985) (same); Franklin v. Lovitt Equip. Co., Inc., 420 So. 2d 1370, 1373 (Miss. 1982) (same); Brewster v. Bubba Oustalet, Inc. 231 So. 2d 189, 189 (Miss. 1970) (same); International Order of Twelve, Knights & Daughters of Tabor v. Marshall, 195 So. 2d 66, 69 (Miss. 1967) (same); Allen v. Thompson, 248 Miss. 544, 557, 158 So. 2d 503, 508 (1963) (same); McMahon v. McMahon, 247 Miss. 822, 836, 157 So. 2d 494, 501 (1963) (same); Aponaug Mfg. Co. v. Collins, 207 Miss. 460, 472-73, 42 So. 2d 431, 434 (1949) (same); Martin v. Gill, 182 Miss. 810, 814-15, 181 So. 849, 850 (1938) (same).

[33] 30 AM. JUR. 2D *Evidence* § 1167 (1967); *see also* C. MCCORMICK, *supra* note 28, § 340 (recognizing that fraud must often be proven by clear and convincing evidence); 9 J.

tions have held that arson may be proved by a mere preponderance of the evidence.[34] In *Sundquist v. Hardware Mutual Fire Insurance Co.*,[35] the Supreme Court of Illinois addressed the issue of the standard of proof that must be met by an insurer claiming arson as a defense to its liability on a fire insurance policy.[36] The plaintiff brought suit to recover under certain fire insurance policies for damages sustained when retail furniture covered by those policies was destroyed by fire.[37] The defendant insurance company claimed that the fire was of incendiary origin attributable to the plaintiff and that therefore it was not liable.[38] The Supreme Court of Illinois initially expressed that it had previously adhered to the reasonable doubt rule when the facts alleged in a civil suit constituted a felony.[39] Noting that the reasonable doubt rule had originated in England, the court said it was doubtful whether English courts still applied the criminal standard of proof when a crime was alleged in a civil proceeding.[40] The *Sundquist* court explained that the English rule had been created because, when one was found guilty of a crime in a civil suit in early England, the verdict of the jury stood as an indictment.[41] The court reasoned that since

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WIGMORE, EVIDENCE § 2498 (Chadbourn rev. 1981) (listing jurisdictions which require that fraud be proved by clear and convincing evidence in civil suits).

[34] Comment, *Arson Fraud*, *supra* note 14, at 584; *see, e.g.*, Honeycutt v. Aetna Ins. Co., 510 F.2d 340, 349 (7th Cir.), *cert. denied*, 421 U.S. 1011 (1975) (applying Illinois law, court held arson in civil suit should be proved by preponderance of evidence, even though fraud would be proved by clear and convincing evidence); Brown v. Jerrild, 239 P. 795, 797 (Ariz. 1925) (in civil suit, arson need only be proved by preponderance of evidence but fraud by clear and convincing standard); Klayman v. Aetna Casualty & Sur. Co., 501 P.2d 750, 752 (Colo. Ct. App. 1972) (same); Werner's Furniture, Inc. v. Commercial Union Ins. Co., 39 Ill. App. 3d 59, 349 N.E.2d 616, 620-21 (1976) (same); George v. Travelers Indemn. Co., 81 Mich. App. 106, 265 N.W.2d 59, 62 (1978) (same); Quast v. Prudential Property & Casualty Co., 267 N.W.2d 493, 495 (Minn. 1978) (same); Pacific Ins. Co. v. Frank, 452 P.2d 794, 796 (Okla. 1969) (same); Great Am. Ins. Co. v. K & W Log, Inc., 22 Wash. App. 468, 591 P.2d 457, 459 (1979) (same).

[35] 371 Ill. 360, 21 N.E.2d 297 (1939).

[36] *Sundquist*, 21 N.E.2d at 298.

[37] *Id.*

[38] *Id.*

[39] *Id.* at 299. Citing previous Illinois cases, the Illinois Supreme Court stated that although facts constituting a felony in a civil suit must be proven beyond a reasonable doubt, facts constituting a misdemeanor could be proven by a preponderance. *Id.* The court also stated that it had previously doubted whether the rule requiring facts in a civil suit to be proved beyond a reasonable doubt should apply in Illinois. *Id.*

[40] *Id.*; *see* Kane v. Hibernia Ins. Co., 39 N.J.L. 697, 704 (1877) (stating that *Thurtell* doctrine has never received much support by English courts); Annotation, *supra* note 18, at 1379 (discussing apparent decline of reasonable doubt rule in England).

[41] *Sundquist*, 21 N.E.2d at 299; *see* Fowler v. Wallace, 131 Ind. 346, 31 N.E. 53, 53

neither life nor liberty was at stake in civil suits in the United States, the justification for the rule did not apply.[42] Turning to an exhaustive analysis of American jurisdictions, the *Sundquist* court concluded that Illinois and one other state were the only states which still followed the English rule and that the majority of American jurisdictions applied the preponderance standard when a crime was alleged in a civil proceeding.[43] Since the majority of American jurisdictions had rejected the English rule for the preponderance standard and since the justification for the rule did not apply in the United States, the Supreme Court of Illinois held that when an insurer claims incendiarism as a defense on a fire insurance policy, the insurer need prove his defense by only a preponderance of the evidence.[44]

In *Vicksburg Furniture Manufacturing, Ltd. v. Aetna Casualty & Surety Co.*,[45] the Court of Appeals for the Fifth Circuit attempted to determine what standard of proof the Supreme Court of Mississippi would adopt for civil arson cases.[46] In this diversity action,[47] the plain-

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(1892) (explaining adherence to reasonable doubt rule in United States based on misconception of rationale of English rule). *See generally* NEWELL, DEFAMATION, SLANDER, AND LIBEL 795 (1892) (discussing application of criminal standard of proof in civil suit when crime alleged).

[42] *Sundquist*, 21 N.E.2d at 299-300.

[43] *Id.* at 299. Although the court recognized the abandonment of the application of the criminal standard of proof in civil cases, it did not consider the clear and convincing standard. *Id.* The cases enumerated in *Sundquist* all rejected the beyond a reasonable doubt standard and adopted the preponderance of the evidence standard when facts are alleged in a civil suit which constitute a crime. *Id.* These 27 jurisdictions are listed: Alabama, California, Colorado, Connecticut, Florida, Georgia, Indiana, Iowa, Kentucky, Louisiana, Maryland, Massachusetts, Michigan, Minnesota, Missouri, New Jersey, New York, North Carolina, Ohio, Pennsylvania, South Carolina, Tennessee, Texas, Vermont, Washington, West Virginia, and Wisconsin. *Id.* Although these cases rejected the criminal burden of proof in civil cases for the preponderance standard, some actions in these jurisdictions may require the clear and convincing standard of proof. 30 AM. JUR. 2D, *supra* note 33, § 1167; *see* C. MCCORMICK, *supra* note 28, § 340 (recognizing that certain facts alleged in civil cases must be proved by clear and convincing evidence); 9 J. WIGMORE, *supra* note 33, § 2498 (listing jurisdictions which required that certain facts alleged in civil suit be proved by clear and convincing evidence).

[44] *Sundquist*, 21 N.E.2d at 299-300.

[45] 625 F.2d 1167 (5th Cir. 1980).

[46] *Vicksburg Furniture*, 625 F.2d at 1169.

[47] *Id.* at 1168. These actions in which an insured seeks to recover under an insurance policy are tried in the federal courts on the basis of diversity of citizenship. Kavanagh, *supra* note 11, at 314. In diversity cases, the outcome in a federal court should not differ materially from the result that would have ensued had the case been tried in the state forum. Erie R.R. Co. v. Tompkins, 304 U.S. 64, 72-73 (1938); *see* Guaranty Trust Co. v. York, 326 U.S. 99, 109 (1945) (applying outcome determinative test to determine if state law controls based on *Erie* analysis). Therefore, the federal courts apply state law, which

tiff insured instituted the suit seeking recovery on a fire insurance policy after the defendant insurer refused to pay.[48] Since there was substantial evidence that the fire was of incendiary origin, the insurance company claimed that the plaintiff was responsible for the fire and that the company therefore had no duty to pay for the losses of the plaintiff.[49] In attempting to apply Mississippi law, the Fifth Circuit conceded that there were no Mississippi cases expressing the applicable standard of proof for Mississippi in civil arson cases.[50] Recognizing that the majority of American jurisdictions apply the preponderance standard for cases in which an insurer claimed arson as a defense,[51] the *Vicksburg Furniture* court held that the preponderance of the evidence standard was the correct burden of proof when an insurance company claimed arson as a defense to its liability on a fire insurance policy.[52]

The Supreme Court of Kansas applied a unique rationale in determining the appropriate standard of proof in civil arson cases in *Neises*

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includes the burden of proof applied by that state on this issue. C. McCormick, *supra* note 28, § 349; *see* Palmer v. Hoffman, 318 U.S. 109, 117 (1943) (burden of proof is substantive and federal courts must apply burden of proof of state in diversity actions); Cities Serv. Oil Co. v. Dunlap, 308 U.S. 208, 212 (1939) (same); *see, e.g.*, Boone v. Royal Indemn. Co., 460 F.2d 26, 29 (10th Cir. 1972) (in civil arson case, burden of proof is governed by state law); Ratay v. Lincoln Nat'l Life Ins. Co., 405 F.2d 286, 289 (3d Cir. 1968) (same); Hardware Mut. Ins. Co. v. Jacob Hieb, Inc., 146 F.2d 447, 452 (8th Cir. 1945) (same); Davidson v. State Farm Fire & Casualty Co., 641 F. Supp. 503, 512 (N.D. Miss. 1986) (same); Mize v. Harford Ins. Co., 567 F. Supp. 550, 551-52 (W.D. Va. 1982) (same).

[48] *Vicksburg Furniture*, 625 F.2d at 1167.

[49] *Id.* at 1169.

[50] *Id.* Although the Supreme Court of Mississippi had been confronted with the question of what standard of proof was applicable in civil arson cases in Hartford Fire Ins. Co. v. Associates Capital Corp., 313 So. 2d 404, 407 (Miss. 1975), the court classified the issue of the proper burden of proof as "collateral" in that case and did not decide the appropriate standard of proof for arson. *Id.*

[51] *Vicksburg Furniture*, 625 F.2d at 1169-70; *see* 21 J. Appleman, Insurance Law and Practice § 12682 (1980) (not necessary for insurer to prove arson beyond all reasonable doubt, but preponderance of evidence suffices); 19 G. Couch, *supra* note 12, § 79:477 (preponderance of evidence is standard of proof for civil cases and is correct burden of proof in civil arson cases). The *Vicksburg Furniture* case has been cited in subsequent cases for expressing the Mississippi law on the point of the appropriate burden of proof when incendiarism is alleged in a civil suit. *See, e.g.*, Gardner v. Wilkinson, 643 F.2d 1135, 1137 (5th Cir. 1981) (citing *Vicksburg Furniture*, court held proper burden of proof when insurer claims arson as defense is preponderance of evidence standard); Burress v. Standard Fire Ins. Co., 642 F. Supp. 62, 67 (N.D. Miss. 1986) (same); Davidson v. State Farm Fire & Casualty Co., 641 F. Supp. 503, 507 (N.D. Miss. 1986) (same).

[52] *Vicksburg Furniture*, 625 F.2d at 1170.

v. Solomon State Bank.[53] In *Neises*, the plaintiff filed suit to recover fire insurance proceeds after his house was destroyed by fire.[54] The defendant insurance company claimed the destruction of the house was the result of arson and refused to pay on the policy.[55] The *Neises* court attempted to define the cause of action and establish the appropriate standard of proof by drawing a distinction between the allegations of arson and misrepresentation on a proof of loss form.[56] The court recognized that such a misrepresentation was fraud[57] but considered arson an entirely different type of defense.[58] Arson, as discussed by the court, amounted to a criminal act, but in the context of an insured's committing arson to collect on a fire insurance policy, arson would constitute simply a breach of contract.[59] The court stated that strong principles of public policy prevent an insured from receiving the protection of the courts when he intentionally sets fire to his property in order to collect on a fire insurance policy.[60] Relying on this public policy and on the proposition that arson constituted merely a breach of contract, a civil offense, the Supreme Court of Kansas explicitly rejected the more stringent clear and convincing standard and the reasonable doubt standard and held that an insurer need prove arson as an affirmative defense by only a mere preponderance of evidence.[61]

The First Circuit Court of Appeals of Louisiana considered the issue of the appropriate standard of proof in civil arson cases in the recent case of *Clifton v. Louisiana Farm Bureau Casualty Insurance Co.*[62] The plaintiff in *Clifton* sought to recover on a fire insurance policy after his home was destroyed by fire which was indisputably of incendiary origin. The defendant insurance company claimed that the

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[53] 236 Kan. 767, 696 P.2d 372 (1985).

[54] *Neises*, 696 P.2d at 372.

[55] *Id.*

[56] *Id.* at 378. The misrepresentation on a proof of loss form referred to in *Neises* was simply the action of an insured exaggerating losses when filing a claim on a fire insurance policy. *Id.* Misrepresentation is another available defense to an insurer when an insured fraudulently claims losses which did not in fact result from a fire. Polk, *supra* note 14, at 652.

[57] *Neises*, 696 P.2d at 378. The misrepresentation, or "false swearing" defense, is always deemed to be fraud and is often referred to as the "fraud defense." Comment, *Arson Fraud*, *supra* note 14, at 589-94; *see also* Note, *supra* note 11, at 838-41 (discussing misrepresentation, or false swearing defense).

[58] *Neises*, 696 P.2d at 378.

[59] *Id.*

[60] *Id.*

[61] *Id.*

[62] 510 So. 2d 759, 760 (La. Ct. App. 1987).

plaintiff was responsible for the fire and refused to cover the loss.[63] Since the plaintiff conceded that the fire was deliberately set, the court required only that the defendant prove that the plaintiff had either started the fire or procured another to commit arson.[64] The *Clifton* court stated that the defendant must prove the arson by a preponderance of the evidence.[65] By the time of the *Clifton* decision, the clear majority of American jurisdictions held that the applicable standard of proof when an insurer claimed arson as a defense to its liability on a fire insurance policy was the preponderance of the evidence standard.[66]

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[63] *Clifton*, 510 So. 2d at 759-60.

[64] *Id.* at 760.

[65] *Id.*

[66] Note, *supra* note 11, at 835; *see* Don Burton, Inc. v. Aetna Life & Casualty Co., 575 F.2d 702, 704 (9th Cir. 1978) (applying California law, "the greater weight of the evidence" was sufficient to meet burden of proof for arson when claimed as defense by insurer); Mueller v. Hartford Ins. Co., 475 So. 2d 554, 557 (Ala. 1985) (preponderance of evidence was sufficient when insurer claimed arson); Godwin v. Farmers Ins. Co. of Am., 129 Ariz. 416, 631 P.2d 571, 573 (Ct. App. 1981) (burden of proof for defense of arson was preponderance of evidence); Klayman v. Aetna Casualty & Sur. Co., 501 P.2d 750, 752 (Colo. Ct. App. 1972) (same); Precision Printers, Inc. v. Central Mut. Ins. Co., 175 Ga. App. 890, 334 S.E.2d 914, 917 (1985) (same); Dean v. Insurance Co. of N. Am., 453 N.E.2d 1187, 1194 (Ind. Ct. App. 1983) (same); Koonts v. Farmers Mut. Ins. Ass'n, [235 Iowa 87, 16 N.W.2d 20, 24 (1944) (same); Osvaldo Varane, Inc. v. Liberty, Mut. Ins. Co., 362 Mass. 864, 284 N.E.2d 923, 924 (1972) (same); George v. Travelers Indem. Co., 81 Mich. App. 106, 265 N.W.2d 59, 62 (Ct. App. 1978) (same); Quast v. Prudential Property & Casualty Co., 267 N.W.2d 493, 495 (Minn. 1978) (same); Rothschild v. American Cent. Ins. Co., 62 Mo. 356, 361 (1876) (same); Italian Fisherman, Inc. v. Commercial Union Assurance Co., 215 N.J. Super. 278, 521 A.2d 912, 914 (N.J. Super. Ct. App. Div.), *cert. denied*, 107 N.J. 152, 526 A.2d 211, 211 (1987) (same); Fowler-Barham Ford, Inc. v. Indiana Lumbermans Mut. Ins. Co., 263 S.E.2d 825, 828 (N.C. Ct. App. 1980) (same); Zajac v. Great Am. Ins. Co., 410 N.W.2d 155, 157 (N.D. 1987) (same); Moss v. Nationwide Mut. Ins. Co., 24 Ohio App. 3d 145, 493 N.E.2d 969, 971 (1985) (same); Pacific Ins. Co. v. Frank, 452 P.2d 794, 796 (Okla. 1969) (same); Mutual of Enumclaw Ins. Co. v. McBride, 295 Or. 398, 667 P.2d 494, 495 (1983) (same); Sperrazza v. Cambridge Mut. Fire Ins. Co., 313 Pa. Super. 60, 459 A.2d 409, 410 (1983) (same); Rutledge v. St. Paul Fire & Marine Ins. Co., 334 S.E.2d 131, 138 (S.C. Ct. App. 1985) (held that preponderance of evidence was all that was required to prove civil arson and rejected Carpenter v. Union Ins. Soc'y of Canton, Ltd., 284 F.2d 155, 162 (4th Cir. 1960), where Fourth Circuit applied South Carolina law and required that civil arson, an action in fraud, be proved by clear and convincing evidence); Raphtis v. St. Paul Fire & Marine Ins. Co., 86 S.D. 491, 198 N.W.2d 505, 507 (1972) (defense of arson need be proved by only preponderance of evidence); Aetna Casualty & Sur. Co. v. Parton, 609 S.W.2d 518, 520 (Tenn. Ct. App. 1980) (same); Bufkin v. Texas Farm Bureau Mut. Ins. Co., 658 S.W.2d 317, 320 (Tex. Ct. App. 1983) (same); Belock v. State Mut. Fire Ins. Co., 106 Vt. 435, 175 A. 19, 22 (1934) (same); Great Am. Ins. Co. v. K & W Log, Inc., 22 Wash. App. 468, 591 P.2d 457, 459 (1979) (same); Morgan v. Insurance Co. of N. Am., 146 W. Va. 868, 122 S.E.2d 838, 841 (1961) (same). *But see* Mize v. Harford Ins. Co., 567 F. Supp. 550, 552 (W.D. Va. 1982) (apply-

In the instant case, the Supreme Court of Mississippi classified civil arson as fraud[67] and stated that since the clear and convincing standard applied in claims alleging embezzlement or fraud, there was no justification for creating an exception for arson cases.[68] The court explained that the serious conequences stemming from a charge of fraud required a higher burden of proof than the preponderance of the evidence standard.[69] The court concluded that since Mississippi law required that fraud be proved by clear and convincing evidence, then each element of arson must be proved by clear and convincing evidence when claimed by an insurer as a defense to its liability on a fire insurance policy.[70]

The *McGory* decision placed Mississippi in the small minority of jurisdictions that require clear and convincing evidence to prove civil arson.[71] The classification of arson as fraud in *McGory* ignores important distinctions between the arson defense and common law fraud.[72] A

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ing Virginia law, court held insurer must prove affirmative defense of arson by clear and convincing evidence); Hutt v. Lumbermens Mut. Casualty Co., 95 A.D.2d 255, 466 N.Y.S.2d 28 (1983) (same holding); Jonas v. Northeastern Mut. Fire Ins. Co., 44 Wis. 2d 347, 171 N.W.2d 185, 187 (1969) (where the act in question constitutes a crime, the standard is clear, satisfactory, and convincing). *See generally* 21 J. APPLEMAN, *supra* note 51, § 12229 (minority rule of clear and convincing proof is not even recognized in discussing appropriate standard of proof in civil arson cases); Kavanagh, *supra* note 11, at 314 (recognizing small minority of jurisdictions which applied clear and convincing standard when insurer raised affirmative defense of arson but stating that clear majority of jurisdictions applied preponderance standard); Note, *supra* note 11, at 835 (majority of jurisdictions applied preponderance standard).

[67] McGory v. Allstate Ins. Co., 527 So. 2d 632, 635 (Miss. 1988). The court explained that "civil arson against an insurer, like embezzlement, is an act of fraud." *Id.* The court noted that Alistate's claim against the McGorys was an allegation of an attempt to defraud Allstate by the McGorys' deceitful act of deliberately destroying their insured property in order to collect on the fire insurance policy. *Id.*

[68] *Id.* at 635-36. In the absence of any distinction between fraud cases and fraud by arson cases, the court viewed an exception for arson cases as "arbitrary" and unfounded. *Id.* at 636.

[69] *Id.* at 635. The *McGory* court explained that the different standards of proof reflect the degree of confidence that a court demands when certain facts are alleged. *Id.* The court noted that the variations of proof required by respective causes of action display the court's "willingness to risk error." *Id.*

[70] *Id.* at 636. The court stated that the nature and consequences of an accusation of fraud required that the courts grant the accused a higher degree of protection than the preponderance standard. *Id.* After the court found no reason to create an exception for arson cases, the court deemed the clear and convincing evidence standard to be the appropriate degree of protection that should be afforded one accused of fraud by civil arson. *Id.*

[71] *See supra* notes 14, 19, 34, 43-44, 51, 66 and accompanying text.

[72] *See supra* notes 28, 34, 53-61 and accompanying text.

party alleging common law fraud in Mississippi is required to prove nine elements by clear and convincing evidence,[73] whereas the arson defense contains merely three elements that must be proved.[74] The arson defense also differs from common law fraud in that it arises in a contractual setting.[75] The Kansas Supreme Court recognized in *Neises v. Solomon State Bank* that when an insurance company seeks to void an insurance contract because of arson, the substance of the allegation is breach of contract and not common law fraud.[76] Arson may constitute a breach of an express provision in a particular insurance contract, but if a fire insurance contract does not contain provisions of which arson may be a breach, an insured's willful destruction of his insured property surely constitutes a breach of the implied covenant of good faith and fair dealing.[77] The contractual context of the arson defense dictates that the preponderance standard be considered appropriate in insurance arson cases, since Mississippi and all other jurisdictions apply the preponderance standard in breach of contract cases.[78]

The justification for the earlier cases that required a higher standard of proof than a preponderance of the evidence when a crime was alleged in a civil suit was based on the English rule that a verdict against the accused in a civil suit could operate as an indictment.[79] Courts in the United States have generally discontinued the requirement of a higher burden than the usual preponderance standard in civil suits because neither life nor liberty is at stake in civil actions.[80] The policy behind the *McGory* decision, and in most other jurisdictions holding as *McGory* did, apparently is some hybrid form of the English doctrine, and therefore has no valid justification in American

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[73] The nine elements required to be proved by clear and convincing evidence when one alleges common law fraud in Mississippi are : (1) a representation; (2) its falsity; (3) its materiality; (4) the speaker's knowledge of its falsity or ignorance of its truth; (5) his intent that it should be acted on by the hearer and in the manner reasonably contemplated; (6) the bearer's ignorance of its falsity; (7) his reliance on its truth; (8) his right to rely thereon; and (9) his consequent and proximate injury. Franklin v. Lovitt Equip. Co., 420 So. 2d 1370, 1373 (Miss. 1982).

[74] *See supra* note 13 and accompanying text.

[75] *See supra* notes 53-61 and accompanying text.

[76] *See supra* notes 56-61 and accompanying text.

[77] *See generally* U.C.C. § 1-203 (1988) ("every contract . . . imposes an obligation of good faith in its performance or enforcement."); RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981) (duty of good faith and fair dealing in performance of contracts).

[78] *See supra* note 61 and accompanying text.

[79] *See supra* notes 16-18 and accompanying text.

[80] *See supra* notes 19-20, 42-44 and accompanying text.

jurisprudence.[81]

The application of the clear and convincing standard in *McGory* was not only inappropriate for this civil arson case; it also imposed an inequitable "double standard" under which the insurer must prove arson (attempted fraud by the insured) by clear and convincing evidence,[82] while the insured need only prove bad faith (actual or attempted fraud by the insurer) by a preponderance of the evidence.[83] The primary import of the *McGory* decision for Mississippi law is that the affirmative defense of arson will be very difficult to prove for an insurer, since the evidence must be almost conclusive that the insured committed arson.[84] Since an act of arson is seldom seen, the clear and convincing standard will be difficult to meet. The higher standard of proof adopted in *McGory* seems logically to dispose of the rule allowing circumstantial evidence to prove arson, because evidence of that nature cannot usually be clear, precise, and indubitable.[85]

This requirement that the evidence be clear and convincing for an insurance company to succeed on its affirmative defense of arson should also cause insurance companies to raise fire insurance rates as the companies tabulate this higher burden of proof as an increased risk. Ultimately, the members of society that will suffer the most from the application of this higher burden of proof are those in lower economic classes, as fire insurance rates increase and insurance companies become less willing to grant fire insurance to those who may have a motive to commit arson.

In sum, the *McGory* decision is inconsistent with modern American jurisprudence;[86] it ignores the distinction between common law fraud and the breach of contract accomplished by arson;[87] and it im-

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[81] *See supra* notes 19-20, 40-44 and accompanying text.

[82] *See supra* notes 67-70 and accompanying text.

[83] *See, e.g.*, Independent Life & Accident Ins. Co. v. Peavy, 528 So. 2d 1112, 1117 (Miss. 1988) (court approved preponderance standard for imposing bad faith liability for "fraudulent or outrageous conduct" on part of insurer); Blue Cross & Blue Shield, Inc. v. Maas, 516 So. 2d 495, 498 (Miss. 1987) (court approved instruction allowing imposition of punitive damages for actions "of a wanton, malicious or fraudulent nature" on preponderance of evidence standard).

[84] *See supra* note 28 and accompanying text.

[85] *See supra* notes 10, 28 and accompanying text.

[86] *See supra* notes 14, 19, 34, 43-44, 51, 66 and accompanying text.

[87] *See supra* notes 56-61, 77, 78 and accompanying text.

poses an inequitable "double standard" with respect to the question of proof in arson and bad faith insurance cases.[88]

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[88] *See supra* notes 82-84 and accompanying text.

Constitutional Law — Tenth Amendment — The Constitution Does Not Prohibit a Nondiscriminatory Tax Exacted from Government Bondholders Merely Because the Economic, but Not the Legal, Incidence of Such Tax Falls upon the Government, Whether State or Federal

Plaintiff[1] invoked original jurisdiction in the United States Supreme Court[2] contending that section 310 (b)(1) of the Tax Equity and Fiscal Responsibility Act (TEFRA),[3] which removed federal income tax exemption for interest earned on unregistered state and local government bonds,[4] violated the tenth amendment[5] and the doctrine of

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[1] Plaintiff was the State of South Carolina. South Carolina v. Baker, 108 S. Ct. 1355, 1359 (1988). The National Governors Association (NGA) intervened. *Id.*

[2] *Id.* The United States Constitution in pertinent part sets forth, "In all cases . . . in which a State shall be a Party, the Supreme Court shall have original Jurisdiction." U.S. Const. art. III, § 2, cl. 2. In South Carolina v. Regan, 465 U.S. 367, 382 (1984), the Supreme Court granted plaintiff's motion for leave to file a complaint against defendant, Donald T. Regan, Secretary of the Treasury of the United States. *Baker*, 108 S. Ct. at 1359. Thereafter, James A. Baker III was appointed Secretary of the Treasury, consequently becoming the defendant in the instant case. *Id.*

[3] *Baker*, 108 S. Ct. at 1358. Subsection (a) of I.R.C. § 103 provides, "Gross income does not include interest on any State or local bond." I.R.C. § 103(a) (1986). Section 310(b)(1) of TEFRA created § 103(j)(l) of the Internal Revenue Code of 1954, which later became § 149(a) when tax-exempt bond provisions were recodified by the Tax Reform Act of 1986. I.R.C. § 103(j)(1) (1982), *recodified at* I.R.C. § 149(a) (1986). TEFRA provides, "Nothing in section 103(a) or in any other provision of law shall be construed to provide an exemption from Federal income tax for interest on any registration-required hond unless such bond is in registered form." *Id.*

[4] *Baker*, 108 S. Ct. at 1358-59. Section 103(j)(l) removed federal income tax exemption for interest earned on all publicly offered long-term bonds regardless of whether such bonds were issued by federal, state or local governments, or private corporations, unless such bonds were issued in registered, as opposed to bearer, form. *Id.* TEFRA required the United States to issue publicly offered bonds with a maturity of one year or more in registered form. *Id.* at 1359. Corporations, as well as holders of unregistered corporate bonds, lost tax deductions as a penalty for nonregistration. *Id.* Registered and bearer bonds differed most significantly in the mechanisms used for transferring ownership and making payments. *Id.* at 1358. While ownership of a registered bond required the payee's name to be recorded on a central list, ownership of a bearer bond was presumed from possession. *Id.* When ownership of a registered bond was transferred, the change had to be recorded on a central list. *Id.* Transfer of a bearer bond occurred by physically handing over the bond, and the bond-owner obtained interest payments by presenting hond coupons to a bank. *Id.* The owner of a registered bond, as determined by the record, automatically received interest payments by check or electronic transfer of funds. *Id.* Congress designed § 310 of TEFRA to reduce the federal deficit by requiring

intergovernmental tax immunity.[6] A Special Master[7] recommended entering judgment for defendant.[8] Plaintiff filed exceptions to the legal conclusions and factual findings of the Special Master.[9] Overruling the

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registration of bonds to hamper the ability of noncompliant taxpayers to conceal income and property from the reach of income, estate, and gift taxes. *Id.* at 1359; *see* S. REP. No. 494, 97th Cong., 2d Sess. 242, *reprinted in* 1982 U.S. CODE CONG. & ADMIN. NEWS 781, 995 (system of reporting could not be achieved as long as bearer instruments were issued). Congress had decided that requiring registration would help prevent tax evasion because bearer bonds often represented unreported income that, without a system of recorded ownership, became difficult for the Internal Revenue Service to trace. *Baker*, 108 S. Ct. at 1358; *see Hearings on H.R. 6300 Before the House Comm. on Ways and Means*, 97th Cong., 2d Sess. 35 (1982) (testimony of John Chapotoon, Assistant Secretary of the Treasury for Tax Policy) (discussing use of bearer bonds as medium of exchange in illegal sector).

[5] *Baker*, 108 S. Ct. at 1359. The tenth amendment to the United States Constitution states, "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." U.S. CONST. amend. X. Plaintiff, South Carolina, argued that the national political process failed because Congress voted for TEFRA while relying on incomplete information that taxpayers concealed taxable income using bearer bonds. *Baker*, 108 S. Ct. at 1360-61. Therefore, this defect in the political process rendered congressional regulation of state activities invalid under the tenth amendment. *Id.* Plaintiff-in-intervention, NGA, argued that TEFRA overreached the tenth amendment limit on Congress' authority to regulate state activities because it commandeered the legislative and administrative processes of states into enacting legislation authorizing bond registration. *Id.* at 1361. For purposes of a tenth amendment analysis, the Supreme Court treated § 310 as if it prohibited outright the issuance of bearer bonds. *Id.* at 1360.

[6] *Baker*, 108 S. Ct. at 1359. The doctrine of intergovernmental tax immunity prevented state and federal governments from levying taxes directly upon one another. *Id.* at 1366. Under this doctrine, states could not tax the United States directly but could tax any private parties with whom it did business as long as the tax did not discriminate against the United States, even though the financial burden fell upon the federal government. *Id.* The rule was substantially the same with respect to state tax immunity. *Id.* Plaintiff argued that TEFRA violated the doctrine by imposing a federal tax on the interest earned on unregistered state bonds. *Id.* at 1362.

[7] *Id.* at 1359-60. The Supreme Court in South Carolina v. Regan, 466 U.S. 948, 948 (1984) assigned Honorable Samuel J. Roberts as Special Master to conduct hearings, evaluate evidence, and submit a recommendation. *Baker*, 108 S. Ct. at 1359.

[8] *Baker*, 108 S. Ct. at 1360. The Special Master concluded that the statute was a constitutional assertion of congressional authority. *Id.*

[9] *Id.* Specifically, plaintiff excepted to 28 findings of the Special Master, including findings (1) that the municipal bond market would have moved to a registered book entry system on its own if TEFRA had not been enacted, (2) that the increased cost and burden of registration was not so onerous as to interfere with the operation of state governments, (3) that registration facilitated tax avoidance and income concealment, (4) that the registration requirement had not had any substantive effect on the ability of the states and localities to raise debt capital, and (5) that the tax sanction did not burden the states' borrowing power. Exceptions of the State of South Carolina to the Report of

exceptions,[10] the United States Supreme Court, *held*, judgment for defendant. The Constitution does not prohibit a nondiscriminatory tax exacted from government bondholders merely because the economic, but not the legal, incidence of such tax falls upon the government, whether state or federal. *South Carolina v. Baker*, 108 S. Ct. 1355 (1988).

The doctrine of intergovernmental tax immunity was not founded upon any express constitutional provision, but rather originated under the tenth amendment through necessary implication.[11] Intergovernmental tax immunity, a judicially created doctrine,[12] emerged to protect states from the federal government's taxing powers.[13] The groundwork for this principle was laid early in the nineteenth century by the landmark decision *McCulloch v. Maryland*.[14] In that case, the Supreme Court unanimously invalidated a state tax[15] levied against a federally chartered bank.[16] Chief Justice Marshall, writing for the Court, grounded federal immunity from state taxation on the supremacy

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the Special Master and Brief in Support Thereof at 8-16, *Baker* (No. 88-94).

[10] *Baker*, 108 S. Ct. at 1368-69. The Supreme Court found the statute in conformity with the tenth amendment and the intergovernmental tax immunity doctrine and overruled plaintiff's exceptions. *Id.*

[11] *See* Davie & Zimmerman, *Tax-Exempt Bonds After the South Carolina Decision*, 39 TAX NOTES 1573, 1575 (1988) (discussing history of intergovernmental tax immunity and effect of *Baker* decision on market for municipal bonds); Comment, *The Constitutionality of Federal Income Taxation of Interest Earned on State Municipal Bonds*, 50 ALB. L. REV. 55, 63 (1985) (authored by Lucretia Marie Adymy) (constitutional basis for intergovernmental tax immunity supported by law of self-preservation under dual federalism system of government).

[12] *See* Engdahl, *Sense and Nonsense About State Immunity*, 2 CONST. COMMENTARY 93, 99 (1985) (courts derived doctrine from tenth amendment, which did not confer immunities on state governments but emphasized spirit of federalism).

[13] U.S. CONST. art. 1, § 8, cl. 1. The taxing clause of the Constitution provides, "Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States." *Id.*

[14] 17 U.S. (4 Wheat.) 316 (1819).

[15] *Id.* at 320-21. By an act of the General Assembly of Maryland, all banks operating within the State of Maryland but not chartered by the state were required to pay either a stamp tax on all bank notes issued or a penalty for every offense. *Id.* at 321. Such institutions could relieve themselves from application of the stamp tax by paying an annual fee to the state. *Id.*

[16] *Id.* at 317. Congress chartered the Second Bank of the United States in 1816 and established a branch office in Baltimore, Maryland, in 1817. *Id.* The state had not granted Congress the authority to establish this branch office, and it sued McCulloch, the cashier of the Baltimore branch, for payment of statutory penalties. *Id.* at 318.

clause[17] and concluded that there must always be subtracted from the Constitution the right of each sovereign to perform its separate function.[18] This reasoning was thereafter extended to bestow tax immunity status upon the federal government and to instrumentalities necessary to carry out governmental functions.[19]

Several years later the Court in *Collector v. Day*[20] relied upon the constitutional reasoning of *McCulloch* and its progeny[21] to confer tax immunity upon a state judicial officer.[22] The Court reasoned that since

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[17] *Id.* at 426. The supremacy clause states, "This Constitution and the Laws of the United States which shall be made in Pursuance thereof . . . shall be the supreme Law of the Land . . . any Thing in the Constitution or Laws of any State to the contrary notwithstanding." U.S. CONST. art. VI, § 2.

[18] *McCulloch*, 17 U.S. at 436. In striking down the state tax, the Court relied in part on the principle that the Constitution created two separate and distinct sovereignties, each being independent of the other in its specific and reserved powers. *Id.* As noted by Chief Justice Marshall, "[t]he power to tax involves the power to destroy." *Id.* at 431. Thus, granting states the power to tax federal instrumentalities necessarily allowed states to burden and control the operations of national government. *Id.* at 436; *see* 45 CONG. REC. 1696 (1910) (discussing *McCulloch* decision and concluding that state governments in their reserved powers were as much beyond control of national government as national government was beyond control of state governments).

[19] Weston v. City of Charleston, 27 U.S. (2 Pet.) 449, 469 (1829). The *Weston* Court applied the reasoning of *McCulloch* to invalidate a city tax imposed upon stock of the United States. *Id.* The Court reasoned that such a tax was essentially levied on a United States contract, thereby inhibiting the federal government's power to borrow money on the credit of the United States. *Id.* at 467. The Court acknowledged that state sovereignty extended over all which existed by the state's own authority. *Id.* However, the Court concluded that state sovereignty did not extend to those means employed by Congress to execute the powers conferred on it by the people of the United States. *Id.* Thus the tax was determined unconstitutional because it impinged on the federal government's power to borrow money. *Id.* Thereafter, in Dobbins v. Commissioners of Erie County, 41 U.S. (16 Pet.) 435, 450 (1842), taxation immunity was extended to exempt a federal officer's employment compensation from state assessments. *Id.* The Court premised the extension upon the reasoning that Congress had determined what compensation should be given to the officer, and that any state law imposing a tax upon such compensation conflicted with the laws of the United States. *Id.* at 449-50.

[20] 78 U.S. (11 Wall.) 113 (1871).

[21] *See Dobbins*, 41 U.S. at 450 (invalidating county tax levied on employment compensation of federal officer); *Weston*, 27 U.S. at 465-67 (invalidating city tax imposed on issuance of federal debt instrument); *McCulloch*, 17 U.S. at 429 (invalidating state taxation of federal bank).

[22] *Collector*, 78 U.S. at 113-14. Congress had assessed a federal income tax against the salary of a Massachusetts judge. *Id.* State law determined judicial salaries which were paid from Massachusetts' treasury. *Id.* at 114. The judge paid the tax under protest and sued for a refund. *Id.* In conferring immunity, the Supreme Court reasoned that the federal government could not tax salaries of state judicial officers because they were instrumentalities of state government. *Id.* at 127.

the means and instrumentalities employed by the federal government were exempt from taxation by the states, state instrumentalities were equally exempt from federal taxation.[23] Hence, intergovernmental tax immunity between federal and state governments was established.[24] The Court based its holding upon the reserved rights of the states[25] and the equality of state and federal governments implicit in the tenth amendment.[26] Thus a tax upon the means and instrumentalities employed by a government, state or federal, to carry out its necessary operations was constitutionally impermissible in accordance with the law of self-preservation.[27] Subsequently, in the 1895 landmark decision *Pollock v. Farmers' Loan & Trust Co.*,[28] the Court expanded intergovernmental tax immunity previously shared by state and federal governments to grant tax immunity upon interest earned on municipal bonds.[29] Relying on earlier precedent,[30] the Court found that a federal

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[23] *Id.* at 127. Relying on *Dobbins* and *Weston*, the *Collector* Court determined that the exemption rested upon the law of self-preservation. *Id.* Concurring with *McCulloch*, the Court noted that despite the fact that states were not expressly prohibited by the Constitution from taxing means or instrumentalities of the federal government, such prohibition rested upon necessary implication; otherwise, the states might impair or even destroy the operations of federal authorities. *Id.* at 123-24. Therefore, in light of the dual system of government created by the Constitution, such implication must also prevent federal taxation of state instrumentalities. *Id.* at 125-26.

[24] *Id.* at 127. The *Collector* Court's reliance on *McCulloch* to establish reciprocal tax immunity between state and federal governments has been criticized as an improper interpretation of that case. Martori & Bliss, *Taxation of Municipal Bond Interest—"Interesting Speculation" and One Step Forward*, 44 NOTRE DAME LAW. 191, 193 (1968).

[25] *Collector*, 78 U.S. at 128. The Court stated that the right to pass laws, to give effect to laws through executive action, to administer justice through the courts and to employ the necessary agencies to carry out legitimate purposes of state government were not proper subjects of the taxing power of Congress. *Id.*

[26] *Id.* at 126.

[27] *Id.* at 127.

[28] 157 U.S. 429 (1895), *rev'd on other grounds*, 158 U.S. 601 (1895).

[29] *Pollock*, 157 U.S. at 586. The *Pollock* Court invalidated an act which imposed a federal income tax on rental income from real estate holdings and interest income earned on municipal debt obligations. *Id.* at 583, 586. At such time, the Constitution mandated that no direct tax could be levied by the federal government other than by apportionment. *Id.* at 580. Thus, *Pollock* invalidated any direct personal income tax which was not fairly apportioned among the states. *Id.* at 582-83. However, the sixteenth amendment eliminated the apportionment requirement by granting Congress the "power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." U.S. CONST. amend. XVI. Thus, only a portion of *Pollock* was overruled by constitutional amendment; therefore, the invalidation of the federal tax imposed upon municipal bond interest remained valid precedent. *See* 45 CONG. REC. 1697-98 (1910) (establishing remaining

income tax imposed on such bond interest violated the doctrine of intergovernmental tax immunity as developed in *McCulloch* and succeeding cases.[31] The Court further found that bonds issued by public municipalities were a means for carrying on the work of government, and a tax on such instruments effectively prohibited the state from carrying out its governmental functions.[32] Therefore, the interest income from government issued bonds was immune from taxation even though the purchaser of the bond, rather than the government, was directly responsible for payment of the tax.[33]

Following *Pollock*, the doctrine of intergovernmental tax immunity developed in a broad fashion[34] until the latter 1930's, when the

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validity of *Pollock* after sixteenth amendment to suppress fears that taxing powers would become limitless); Goldberg, *A Call to Action: State Sovereignty, Deregulation and the World of Municipal Bonds*, 13 URB. LAW. 253, 257 n.9 (1981) (viability of *Pollock* ruling remained to immunize securities issued by state's political subdivisions). In Evans v. Gore, 253 U.S. 245, 261 (1920), the Supreme Court clearly refuted arguments that ratification of the sixteenth amendment subjected interest on municipal bonds to federal taxation by concluding that the amendment merely removed all occasions existing for an apportionment among the states. *Id.*; *see* National Life Ins. Co. v. United States, 277 U.S. 508, 521 (1928) (reaffirmed *Pollock* by holding tax on interest earned on state bonds was unconstitutional).

[30] *Pollock*, 157 U.S. at 585-86 (citing Weston v. City of Charleston, 27 U.S. (2 Pet.) 449, 479-80 (1829)). In support of its conclusion, the *Pollock* Court relied primarily upon the reasoning of Chief Justice Marshall in *Weston*. *Pollock*, 157 U.S. at 585-86. The same consideration which existed in *Weston* also existed in *Pollock* to prevent federal taxation of state debt instruments, in that both challenged taxes were taxes upon the power of a government and its instrumentalities to borrow money. *Id.* at 586.

[31] *Pollock*, 157 U.S. at 586. The *Pollock* Court concluded that a municipal corporation was an instrumentality of a state and that properties and revenues of the municipality were therefore immune from federal taxation. *Id.* Adhering to the reasoning set forth in *Weston*, the Court resolved that a tax on the interest of municipal securities operated on the state's power to borrow money and thus impaired a state's main source of financing. *Id.* Hence, the same lack of power to tax a state or its instrumentalities, as set forth in *Collector*, was extended to immunize income derived from its securities. *Id.* at 585.

[32] *Id.* at 585 (citing Mercantile Bank v. New York, 121 U.S. 138, 162 (1887)). The *Pollock* Court determined that it was not the policy of the government issuing the bonds to subject them to taxation. *Id.*

[33] *Pollock*, 157 U.S. at 586; *see* Farmers & Mechanics Sav. Bank v. Minnesota, 232 U.S. 516, 521-28 (1914) (state tax on bonds was in effect tax upon right of municipality to issue them); Ambrosini v. United States, 187 U.S. 1, 7-8 (1902) (license bonds exacted by municipalties not subject to federal taxation); United States v. Baltimore & O.R.R., 84 U.S. (17 Wall.) 322, 327-33 (1872) (monies owed to municipality by privately owned railway were immune from federal taxation).

[34] *See* Gillespie v. Oklahoma, 257 U.S. 501, 506 (1922) (unconstitutional to tax income derived from lands leased from federal government); Panhandle Oil Co. v. Knox, 227 U.S. 218, 222 (1918) (vendor immune from state sales tax on proceeds from sale to United States). Cases dealing with tax immunity of income derived from state contracts

Court began to narrow the scope of such immunity.[35] In accordance with this new approach, the Court in *Graves v. New York ex rel. O'Keefe*[36] reversed its earlier position[37] and held that federal or state employees and officers were no longer considered immune governmental instrumentalities.[38] The Court, in upholding the constitutional validity of a state income tax levied upon the salary of a federal employee,[39] reasoned that a tax on income was neither legally nor economically a tax upon its source.[40] Furthermore, the indirect eco-

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freely cited principles set forth in federal tax immunity cases, and vice versa. *See* Burnet v. Coronado Oil & Gas Co., 285 U.S. 393, 400-01 (1932) (federal government may not tax income derived from sale of oil and gas produced from land under lease by state); Indian Motorcycle Co. v. United States, 283 U.S. 570, 577-79 (1931) (proceeds derived from sale to state agency immune from federal taxation). *But see* Burnet v. Jergins Trust, 288 U.S. 508, 514-16 (1932) (federal tax on receipts of lessee was not invalid since subject taxed was remote from any governmental function); Group No. 1 Oil Corp. v. Bass, 283 U.S. 279, 283-84 (1931) (when property, or any interest therein, had completely passed from government, profits derived by sale of oil were not immune from taxation simply because property was once owned by government or because sale carried out some government purpose); Willcuts v. Bunn, 282 U.S. 216, 227 (1931) (profits derived from sale of government bonds, after being issued by State, were taxable even though tax on interest was forbidden). *See generally* Powell, *The Waning of Intergovernmental Tax Immunities*, 58 HARV. L. REV. 633, 635-38 (1945) (historical development of expansive intergovernmental immunity doctrine).

[35] *See, e.g.*, James v. Dravo Contracting Co., 302 U.S. 134, 160 (1937) (refusing to extend intergovernmental tax immunity). Taxation immunity began to decline when the *Dravo* Court determined that independent contractors employed by the federal government to construct locks and dams for navigational purposes were not government instrumentalities as required for taxation immunity. *Id.* The Court stated that tax exemption status could not be invoked just because a tax on a contractor increased costs to the government. *Id.* at 134. The Court concluded that taxation upon persons and state corporations employed in government service was not unconstitutional absent congressional legislation to the contrary. *Id.* at 161; *see* Note, *The Dravo Case and Intergovernmental Tax Immunity*, 51 HARV. L. REV. 707, 713 (1938) (analysis of constitutional basis for opinion in light of conflicting precedents).

[36] 306 U.S. 466 (1939).

[37] *Graves*, 306 U.S. at 486; *see* Brush v. Commissioner, 300 U.S. 352, 366-74 (1937) (salary of city engineer of water system immune from federal taxation); New York *ex rel.* Rogers v. Graves, 299 U.S. 401, 408 (1937) (salary paid to employee of corporation created by federal government was immune from state taxation); Collector v. Day, 78 U.S. (11 Wall.) 113, 127 (1817) (salary of state judge immune from federal income tax).

[38] *Graves*, 306 U.S. at 487. The Court upheld a nondiscriminatory tax levied upon the salary of an examining attorney employed by the Federal Home Owner's Loan Corporation, a congressionally authorized instrumentality of the United States. *Id.* at 486-87.

[39] *Id.* at 487.

[40] *Id.* at 480. The Court reasoned that the salary of an employee or officer, when received as compensation for federal or state government employment, became the indi-

nomic burden imposed upon the government by a tax was not, in itself, a sufficient reason to invoke tax immunity.[41]

Expanding on the reasoning of *Graves*, the Court in *Alabama v. King & Boozer*[42] completely rejected a claim that a nondiscriminatory tax levied upon a private entity, the cost of which was passed on to the government, unconstitutionally burdened governmental functions.[43] The *King & Boozer* Court upheld a state sales tax levied upon materials used by private contractors to construct an army camp for the United States.[44] The Supreme Court held that in order to invoke tax

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vidual property of the taxpayer. *Id.* Accordingly, a tax levied on such compensation was paid by the employee out of his private funds and not by the employer. *Id.* The Court determined that the economic burden of such tax was not imposed upon the government employer. *Id.* at 486. Thus, the test enunciated for tax immunity was whether the tax unduly interfered with the operations of government. *Id.* at 486-87. The Court concluded that denying taxation immunity to employees and officers of the respective governments would not obstruct or interfere with governmental functions. *Id.* at 486.

[41] *Id.* at 483; *see* Oklahoma Tax Comm'n v. Texas Co., 336 U.S. 342, 353-55 (1949) (federal tax on gross income derived from state lease constitutional); Helvering v. Gerhardt, 304 U.S. 405, 424 (1938) (overturning *Collector* decision and holding federal taxation of state employees constitutional); Helvering v. Mountain Producer Corp., 303 U.S. 376, 386-87 (1938) (nondiscriminatory tax on government contract constitutional); Helvering v. Therrell, 303 U.S. 218, 225 (1938) (federal income tax upon nonessential state employees constitutional); Helvering v. Powers, 293 U.S. 214, 224-27 (1934) (salaries of state trustees operating street railway were not constitutionally immune from federal income tax); Metcalf & Eddy v. Mitchell, 269 U.S. 514, 526 (1926) (federal tax upon contractor with state government did not interfere with state instrumentalities in carrying out traditional functions). *See generally* Case Comment, *Taxation—Federal Instrumentalities—State Taxation of Leases of Indian Lands*, 17 GEO. WASH. L. REV. 570, 572 (1949) (advocating that private individuals no longer be granted governmental immunity absent substantial burden upon government).

[42] 314 U.S. 1 (1941).

[43] *King & Boozer*, 314 U.S. at 14. In upholding a tax levied upon a government contractor, the Court stated:

> The Government, rightly we think, disclaims any contention that the Constitution, unaided by Congressional legislation, prohibits a tax exacted from the contractors merely because it is passed on economically, by the terms of the contract or otherwise, as part of the construction cost to the Government. So far as such a non-discriminatory state tax upon the contractor enters into the cost of the materials to the Government, that is but a normal incident of the organization within the same territory of two independent taxing sovereignties.

Id. at 8-9.

[44] *Id.* at 6. King and Boozer sold lumber on the order of "cost-plus-a-fixed-fee" to contractors who were constructing an army camp for the United States. *Id.* The Court determined that the contractors were the purchasers of the materials within the meaning of the taxing statute. *Id.* at 12. Therefore, it was concluded that title to the materials passed to the government upon delivery, and thus the government was not obligated to the contractor's vendor for payment of the sales tax. *Id.* at 13-14. Accordingly, the tax

immunity, the challenged tax must interfere with functions essential to the maintenance of government.[45] Hence, the constitutionality of taxation turned on whether the activity sought to be taxed had a governmental, as opposed to a proprietary, function.[46] If an activity was governmental in nature, it was essential to the maintenance of government.[47]

In *New York v. United States*,[48] however, the Court rejected the "governmental/proprietary" distinction as being untenable.[49] In so doing, the Court upheld the constitutional validity of a federal income tax levied upon mineral waters bottled and sold by the state.[50] In dictum, the Court recognized that the emphasis of recent intergovernmental tax immunity cases had shifted from immunity from taxation, to limitation upon immunity.[51] In view of such change, the Court held that so long as Congress generally taxed a source of revenue by whomever earned and such revenue was not uniquely capable of being

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was considered a valid execution of state authority and did not infringe the government's immunity, regardless of the contract's cost-plus nature. *Id.* at 14.

[45] *See Gerhardt*, 304 U.S. at 424 (tax must curtail those functions essential to continued existence of states).

[46] *See, e.g.*, Ohio v. Helvering, 292 U.S. 360, 369 (1934) (where state engaged in business of private nature, it exercised nongovernmental functions and was not immune from federal taxing power); South Carolina v. United States, 199 U.S. 437, 463 (1905) (vendors acting as agents of state not immune from federal taxation when acting in proprietary capacity).

[47] *South Carolina*, 199 U.S. at 461-63.

[48] 326 U.S. 572 (1946) (plurality opinion).

[49] *New York*, 326 U.S. at 575-76. Justice Frankfurter, speaking for the Court, reviewed and discarded as untenable such legal dichotomies as "governmental versus proprietary," "governmental versus trading," "historically sanctioned versus novel," and "usual governmental function versus activities conducted merely for profit." *Id.* at 583-84. The Court found it sufficient to apply a nondiscriminatory rule: Congress could not tax state activities pursued by private individuals; however, the state could be taxed if private persons were taxed equally, in the same manner and upon the same subject matter. *Id.* at 582-84. The Court discussed the doctrine of state immunity:

> There are, of course, State activities and State-owned property that partake of uniqueness from the point of view of intergovernmental relations. These inherently constitute a class by themselves. . . . These could not be included for purposes of federal taxation in any abstract category of taxpayers without taxing the State as a State.

Id. at 582; *see* Engdahl, *supra* note 12, at 102 (Congress could not tax state activities while leaving untaxed same activities pursued by private individuals but could include states in levying tax exacted equally from private persons).

[50] *New York*, 326 U.S. at 581. The Court concluded that there was no constitutional restriction upon Congress to prohibit the inclusion of the states in levying a tax exacted equally from private persons upon the same subject matter. *Id.* at 583-84.

[51] *Id.* at 581.

earned only by a state, the Constitution would not forbid the tax merely because its incidence also fell upon a state.[52] Following the decision in *New York*, however, the nature of the governmental undertaking remained relevant as a determinative factor in evaluating the taxed activity as an essential governmental function.[53] Thus, tax immunity was granted only if the tax threatened the continued existence of the nontaxing government.[54] If no such threat occurred, tax immunity would not be granted.[55] This analysis was recently applied in *Memphis Bank & Trust Co. v. Garner*,[56] where the Court, held that under the constitutional rule established in *McCulloch*,[57] a state tax levied upon interest income received from federal bond obligations, with no reciprocal provision for similar state obligations, was constitutionally invalid.[58] The Court's adherence to the "governmental/propri-

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[52] *Id.* at 582.

[53] United States v. New Mexico, 455 U.S. 720, 737 (1982). In upholding a state gross receipts tax and compensating use tax on federal government contractors doing business within the state, the Supreme Court determined there was no constitutional taxation immunity merely because the economic burden of such taxation was passed on to the federal government. *Id.* at 734. The Court thereafter declared that tax immunity could only be extended to entities incorporated into the government structure. *Id.* at 737.

[54] *See, e.g.*, Washington v. United States, 460 U.S. 536, 540 (1983) (immunity not invoked merely because financial burden of tax had effect on government); Massachusetts v. United States, 435 U.S. 444, 453 (1978) (registration tax on state aircraft did not violate implied immunity); United States v. City of Detroit, 355 U.S. 466, 473-74 (1958) (no taxation immunity for private parties dealing with government merely because financial burden of tax eventually fell upon government); Oklahoma Tax Comm'n v. Texas Co., 336 U.S. 342, 363 (1949) (no state taxation immunity to lessee of federal government). *But see* United States v. Tax Comm'n, 421 U.S. 599, 610 (1975) (tax was unconstitutional because its legal incidence rested directly upon government instrumentality).

[55] United States v. County of Fresno, 429 U.S. 452, 467-68 (1977). The Court upheld the validity of a state property tax assessed upon United States Forest Service employees residing in homes furnished by the Forest Service, since the tax in no way threatened the existence of a federal function or discriminated against the federal government. *Id.* (citing City of Detroit v. Murray Corp., 355 U.S. 489, 495 (1958)). Economic burden alone was not sufficient to invoke intergovernmental tax immunity. *Id.* at 464. Thus the Court concluded that mere government ownership of the properties would not confer tax immunity upon lessees. *Id.* at 464-65. *See generally* Case Comment, *The Continued Restriction of the Federal Government's Immunity from State Taxation*—United States v. County of Fresno, 26 DE PAUL L. REV. 874, 874-90 (1977) (analyzing impact of *Fresno*).

[56] 459 U.S. 393 (1983).

[57] *Garner*, 459 U.S. at 397. The Court reasoned that where the economic, but not the legal, incidence of the tax fell on the federal government, such tax did not violate constitutional immunity. *Id.*

[58] *Id.* at 398. The tax was levied upon interest income from federal obligations while explicitly exempting interest income earned from state issued obligations, thus violating the nondiscriminatory provisions of the *McCulloch* rule. *Id.*

etary" distinction was a significant factor in its conclusion[59] that the discriminatory element of the assessment necessitated its invalidation.[60]

In a controversial decision, the Supreme Court in *Garcia v. San Antonio Metropolitan Transit Authority*,[61] seriously attenuated the validity of the doctrine of intergovernmental tax immunity[62] as previously implied under the tenth amendment.[63] The *Garcia* Court abandoned all distinctions formerly employed by the Court[64] made on the basis of essential, traditional, or integral governmental functions.[65] The Court refused to define state regulatory immunity in terms of essential governmental functions.[66] Although *Garcia* pertained to the commerce power under the tenth amendment,[67] the Court referred to problems

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[59] *Id.* at 397. The Court acknowledged that such a tax was generally valid if the legal incidence of such a tax did not fall upon the government. *Id.*

[60] *Id.* at 398.

[61] 469 U.S. 528 (1985).

[62] *See* Howard, *Garcia and the Values of Federalism: On the Need for a Recurrence to Fundamental Principles*, 19 GA. L. REV. 789, 791 (1985) (*Garcia* decision rejected assumption that limiting national government to protect states was part of judicial function).

[63] *See* McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316, 425 (1819) (Constitution provided implied protection to each sovereign government to perform its constitutional duty without encroachment).

[64] *Garcia*, 469 U.S. at 546-47; see *supra* notes 35-60 and accompanying text (discussing cases employing "governmental/proprietary" distinction).

[65] *Garcia*, 469 U.S. at 546-47. The Court determined that neither the "governmental/proprietary" distinction nor any other such arbitrary distinction could faithfully adhere to the role of federalism in a democratic society. *Id.* at 545-46. The Court stated, "Any rule of state immunity that looks to the 'traditional,' 'integral,' or 'necessary' nature of governmental functions inevitably invites an unelected federal judiciary to make decisions about which state policies it favors and which ones it dislikes." *Id.* at 546. Thus the distinction was rejected as unsound in principle and unworkable in practice. *Id.*

[66] *Id.* at 546-47. The *Garcia* Court held that the "governmental/proprietary" rule led to inconsistent results while disserving principles of democratic self governance, thus leading to unacceptable inconsistency. *Id.* at 547.

[67] *Id.* at 537. *See generally* Comment, *supra* note 11, at 78-85 (commerce power and taxing power arise under same constitutional provision). The first article of the Constitution contains both the taxing and commerce powers granted Congress. U.S. CONST. art. I, § 8, cl. 1, cl. 3. The taxing clause provides, "The Congress shall have Power To lay and collect Taxes . . . ." U.S. CONST. art. 1, § 8, cl. 1. The commerce clause grants Congress the power "[t]o regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes . . . ." U.S. CONST. art. 1, § 8, cl. 3. Although the Court historically placed greater limitations upon the taxing power, each carries the same concern in the abstract: state immunity from federal enroachment upon state powers. Comment, *supra* note 11, at 78 n.167. In National League of Cities v. Usery, 426 U.S. 833, 843 n.14 (1976), which has been overruled by *Garcia*, Justice Rehnquist, in his majority opin-

with the "governmental/proprietary" distinction in the area of intergovernmental tax immunity.[68] The Court concluded that constitutional limitations upon congressional authority were inherent in the structure of the federal government.[69] Accordingly, the *Garcia* Court determined that state activities were preserved through the political medium[70] and that the political system was created to serve as the only constitutional limitation upon congressional authority.[71] Hence, absent a defect in the national political process, judicial interpretation of congressional legislation regarding federal regulation over the states was no longer permissible.[72]

In the instant case, the United States Supreme Court found that

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ion, stated:

> Surely the federal power to tax is no less a delegated power than is the commerce power: both find their genesis in Art. 1 § 8. Nor can characterizing the limitation recognized upon the federal taxing power as an "implied immunity" obscure the fact that this immunity is derived from the sovereignty of the States and the concomitant barriers which such sovereignty presents to otherwise plenary federal authority.

Id. Contra United States v. California, 297 U.S. 175, 184 (1936) (principle by which state instrumentalities were protected from federal taxation was inapplicable as limitation upon federal power to regulate interstate commerce).

[68] *Garcia*, 469 U.S. at 543. The inability to give principle content to the distinction between "governmental" and "proprietary," no less significantly than its inherent unworkability, led to the distinction's abandonment. *Id.*; *see* New York v. United States, 326 U.S. 572, 575-76 (1946) (plurality opinion) (discarded use of "governmental/proprietary" evaluation as untenable). The *Garcia* Court rejected sovereignty arguments presented by the states but acknowledged that states unquestionably retained a significant measure of sovereign authority. *Id.* at 549. The Court determined that sovereign authority existed only to the extent the Constitution had not divested states of their original powers and transferred these powers to the federal government. *Id.*; *see* 2 ANNALS OF CONG. 1897 (1791) (interference with power of states no constitutional criterion of congressional power). The Court concluded that the Constitution did not carve out express elements of state sovereignty that Congress could not displace with its delegated powers. *Garcia*, 469 U.S. at 550.

[69] *Garcia*, 469 U.S. at 551-57. The *Garcia* Court was convinced that the fundamental limitation of the constitutional scheme proposed was one of process rather than result. *Id.* at 554. *Contra* Howard, *supra* note 62, at 791-92 (critical analysis of structural approach enunciated in *Garcia*).

[70] *Garcia*, 469 U.S. at 556. The Court found that the political process ensured that laws which unduly burdened the states would not be promulgated. *Id.*; *see* Coyle v. Oklahoma, 221 U.S. 559, 572 (1911) (every congressional act passed by people of United States through elected representatives).

[71] *Garcia*, 469 U.S. at 556-57.

[72] *Id.* at 552. The Court concluded that the sovereign interests of the state were more properly protected by procedural safeguards inherent in the structure of the federal system as opposed to judicially created limitations on federal power. *Id.*

government bonds received no immunity from nondiscriminatory and legitimate taxation[73] and that TEFRA[74] must therefore be upheld as constitutional legislation.[75] The Court also found that because Congress could constitutionally impose federal requirements upon states,[76] the statute was valid even if the states had to amend their present statutes in order to conform.[77] The Court adopted the *Graves*[78] rationale in reasoning that a general nondiscriminatory tax which was passed on economically to the state or national government was but the normal incident of two organized governments within the same territory.[79] Accordingly, the tenth amendment was deemed to provide structural, as opposed to substantive, protection to the sovereign states, and only a defect in the national political process[80] would justify judicial evalua-

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[73] South Carolina v. Baker, 108 S. Ct. 1355, 1368 (1988). The Court concluded that owners of state government bonds could constitutionally be taxed on income earned from such bonds and that states have no constitutional entitlement to issue bonds immune from legitimate taxation. *Id.* at 1367.

[74] I.R.C. § 103(j)(l) (1982), *recodified at* I.R.C. § 149(a) (1986).

[75] *Baker*, 108 S. Ct. at 1368-69. According to the *Baker* Court, the taxation requirement of the statute imposed no direct tax upon states. *Id.* at 1368. The tax was levied upon and collected from bondholders, not state governments. *Id.* The Court concluded that any increased administrative costs incurred by states in implementing the registration system were not taxes within the meaning of the immunity doctrine. *Id.* Additionally, the Court found that the nondiscriminatory nature of the statute effectively disposed of all tenth amendment/intergovernmental tax immunity arguments. *Id.* Under TEFRA, the federal government had directly imposed the same registration requirement on itself, and sanctions for issuing unregistered corporate bonds were comparably severe. *Id.*

[76] *Id.* at 1362. The Court determined that the imposition of federal requirements on states was constitutional even if the requirements could only be satisfied by amending existing state statutes. *Id.* (citing EEOC v. Wyoming, 460 U.S. 226, 253-54 (1983)).

[77] *Id.* The Court reasoned that the validity of congressional legislation could not be contingent upon a state's statutory code. *Id.* The Court concluded that such a contingency would afford any state the ability to immunize its activities from federal regulation by codifying the manner in which it engaged in those activities. *Id.* Furthermore, such an undue restriction upon congressional regulation would render *Garcia* a nullity. *Id.*

[78] Graves v. New York *ex rel.* O'Keefe, 306 U.S. 466, 486 (1939). In upholding the constitutionality of a nondiscriminatory state tax on the salary of federal employees, the *Graves* Court concluded that economic impact alone was insufficient ground to invoke tax immunity. *Id.*

[79] *Baker*, 108 S. Ct. at 1365-66. The Court, following the reasoning of *Graves*, held that economic incidence alone would not invoke tax immunity from an otherwise constitutional assessment. *Id.* at 1366.

[80] *Id.* at 1360. The Court determined that under *Garcia* states must seek tenth amendment protection from congressional encroachment through the structural safeguards of the national political process, not through judicially defined areas of unregulable state activity. *Id.* The Court found that the constitutional concept of state sover-

tion of the substantive basis for congressional legislation.[81] Finally, the Court concluded that the statute was a constitutional act of congressional authority, and the Special Master's recommendation was therefore appropriate.[82]

In a strongly worded dissent,[83] Justice O'Connor argued that the statute should have been invalidated as an unconstitutional assertion of congressional authority since it violated the tenth amendment and principles of federalism inherent in the Constitution.[84] Justice O'Connor further contended that the statute encroached upon state autonomy under the guarantee clause and should have been deemed unconstitutional.[85] Finally, Justice O'Connor concluded that the Court had a continuing responsibility to oversee the federal government's compliance with its constitutional duty toward states[86] and must con-

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eignty was based upon people's reliance on acting through their elected legislative representatives, not through the courts. *Id.* at 1367 n.14 (quoting Garcia v. San Antonio Metro. Transit Auth., 469 U.S. 528, 546 (1985), quoting Helvering v. Gerhardt, 304 U.S. 405, 427 (1938) (Black, J., concurring)). Therefore, TEFRA was constitutionally enacted because plaintiff failed to allege or estahlish that it was deprived of its right to participate in the political process or that it was isolated in some way as to render it politically powerless. *Id.* at 1361.

[81] *Id.* at 1360-61. The Court concluded that nothing in the tenth amendment authorized courts to second-guess the suhstantive basis for congressional legislation. *Id.* at 1361. This conclusion was based upon a recognition that when imposing a nondiscriminatory tax, the federal government could destroy another government by excessive taxation only if it were also willing to destroy itself or its constituents. *Id.* at 1367 n.14.

[82] *Id.* at 1368-69. The Court upheld the validity of § 310 of TEFRA and approved the Special Master's recommendation to enter judgment for Baker, Secretary of the Treasury of the United States. *Id.*

[83] *Id.* at 1370. Justice O'Connor, dissenting, criticized the Court for overruling precedent that had shielded interest paid on state and local bonds from federal taxation for nearly a century. *Id.* Additionally, Justice O'Connor admonished the Court for failing to enforce the constitutional safeguards of state autonomy hy allowing Congress to initiate the erosion of state sovereignty. *Id.* at 1372; *see* L. TRIBE, AMERICAN CONSTITUTIONAL LAW § 5-20, at 301 (2d ed. 1988) (danger of small decisions was prospect that Congress would nibble away state sovereignty, bit by bit).

[84] *Baker*, 108 S. Ct. at 1370. Justice O'Connor viewed the tenth amendment and the inherent principles of federalism in the Constitution as a prohibition against Congress' authority to tax interest paid on state and municipal bonds. *Id.*

[85] *Id.* The guarantee clause of the Constitution provides, "The United States shall guarantee to every State in this Union a Republican form of Government . . . ." U.S. CONST. art. IV, § 4. Justice O'Connor argued that this provision protected states from substantial federal incursions. *Baker*, 108 S. Ct. at 1370; *see* Merritt, *The Guarantee Clause and State Autonomy: Federalism for a Third Century*, 88 COLUM. L. REV. 1, 70-78 (1988) (arguing judicial enforcement of guarantee clause was proper).

[86] *Baker*, 108 S. Ct. at 1371 (quoting Garcia v. San Antonio Metro. Transit Auth., 469 U.S. 528, 581 (1985)).

sider any adverse effects[87] on state governmental functions that result from federal tax measures.[88]

By holding that interest on state and municipal bonds no longer has a constitutional right to exemption from federal taxation,[89] the Supreme Court has acknowledged that the principles of federalism and state sovereignty inherent in the doctrine of intergovernmental tax immunity no longer have any viable application in the area of congressional encroachment.[90] As the doctrine of intergovernmental tax immunity developed, the Court promulgated two requisite criteria for invocation of immunity under the doctrine.[91] First, the challenged tax had to be levied on a means or instrumentality of the government,[92] and second, the activity sought to be taxed had to be essential to the continued existence of that government.[93] However, after fifty years of contracting the expansive nineteenth century interpretation of the doctrine,[94] the Supreme Court in *Garcia* seriously attenuated the doctrine's remaining validity by abandoning the above evaluation.[95] Thus, the Court's emphasis shifted from measuring the damaging effects of the challenged encroachment to relying on the national political process and Congress.[96] Hereafter, the Court will presume that congressional actions which affect states are valid because Congress is composed of statesmen with significant state interests.[97] Although the majority in the instant case attempted to justify the holding by pointing to the indirect nature of the challenged tax,[98] in actuality, they reaffirmed the reasoning of the majority in *Garcia*.[99] Thus the signifi-

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[87] *Id.* Justice O'Connor concluded that the Court had a duty to inquire into the detrimental effects the statute would have upon state and local governments. *Id.* Because the Special Master had found that taxing interest on state and local bonds would substantially increase the cost of borrowing and because long term debt obligations were an essential source of funding for state and local governments, Justice O'Connor complained that the tax would severely hinder governmental operations. *Id.*

[88] *Id.* at 1372. Justice O'Connor relied on constitutional safeguards found in the tenth amendment and the guarantee clause to determine that the Court had failed to protect states against impermissible federal tax initiatives. *Id.*

[89] *See supra* notes 72-73 and accompanying text.

[90] *See supra* notes 69-72 and accompanying text.

[91] *See supra* notes 19-47 and accompanying text.

[92] *See supra* notes 19-34 and accompanying text.

[93] *See supra* notes 35-47 and accompanying text.

[94] *Id.*

[95] *See supra* notes 61-72 and accompanying text.

[96] *See supra* notes 68-72 and accompanying text.

[97] *See supra* notes 68-70 and accompanying text.

[98] *See supra* note 75 and accompanying text.

[99] *See supra* notes 80-81 and accompanying text.

cance of the holding in the instant case has a far more profound effect than the immediate constitutionality of the challenged statute. As feared by Justice O'Connor in her dissent,[100] the Court has declared it constitutional for Congress to be the sole judge of its own powers,[101] a proposition which disregards an essential component of Anglo-American constitutionalism, that no branch of government should be vested with the authority to determine the scope of its own powers.[102] Such a prohibitive measure is especially valid in a federal system that relies upon checks and balances to prevent government self-destruction through corrupt usurpation of power.[103]

There is no easy solution to the problem exposed; however, an eventual remedy might be obtained through judicial realization that federalism and state sovereignty are intrinsic in the constitutional system.[104] Therefore, safeguarding these processes cannot be left to the unreliable and unrestrained discretion of the political branches.[105] The Court must take some initiative in safeguarding such principles from congressional devastation.[106] How sparingly the Court might choose to exercise its initiative is of no relevance; the key is that the political branches would act knowing that the judiciary has power to intervene if necessary.[107]

Myles A. Parker

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[100] *See supra* notes 83-88 and accompanying text.
[101] *See supra* notes 80-81 and accompanying text.
[102] *See supra* notes 69-72 and accompanying text.
[103] *See supra* notes 84-85 and accompanying text.
[104] *See supra* notes 68-69 and accompanying text.
[105] *See supra* note 88 and accompanying text.
[106] *See supra* notes 65-66 and accompanying text.
[107] *See supra* notes 85-88 and accompanying text.

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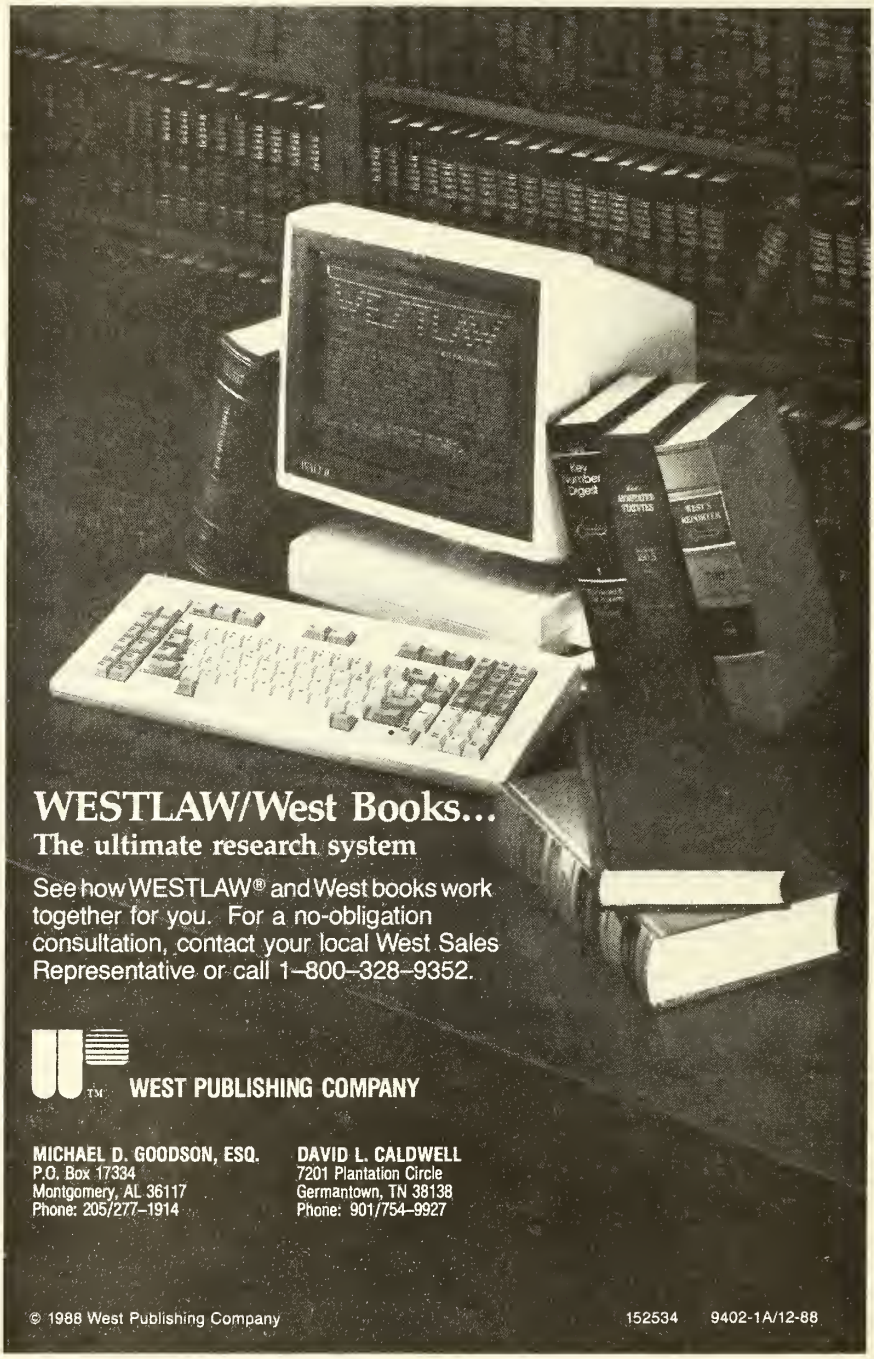

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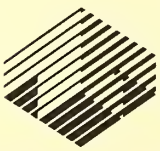

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